S. HRG. 100-595

PAYMENT LIMITATION PROVISIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON
NUTRITION AND INVESTIGATIONS

OF THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

THE ADMINISTRATION AND ENFORCEMENT OF THE $50,000 PER PERSON PAYMENT LIMITATION FOR FARM PROGRAMS

JULY 21, 1987

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CONTENTS

Page

Hearing held on July 21, 1987 1

PAYMENT LIMITATION PROVISIONS

TUESDAY, JULY 21, 1987

Harkin, Hon. Tom, a U.S. Senator from Iowa, opening statement 1
Prepared statement 2
Pryor, Hon. David H., a U.S. Senator from Arkansas 17

CHRONOLOGICAL LIST OF WITNESSES

Beuley, Robert W., Inspector General, Office of the Inspector General, U.S. Department of Agriculture, Washington, DC, accompanied by James Ebbitt, Assistant Inspector General for Audit; and Jack Leavy, Regional Inspector General for Audit, U.S. Department of Agriculture, Temple, TX 3
Prepared statement 6
Brief summary of the four cases and subsequent action by ASCS 15
How much money was involved in these four cases? 16
Audit covered operations at the State office and in Chicot and Jefferson Counties 21
Harman, John W., Associate Director, Resources, Community, and Economic Development Division, General Accounting Office, Washington, DC, accompanied by Edward M. Zadjura, Project Manager, and Cliff Fowler, Group Director 23
Questions submitted by Senator Harkin and the responses thereto 37
Prepared statement 44
Appendix I:
Chart 1: Producers paid $40,000 or more and new persons created by reorganizations among those producers 61
Chart 2: Acreage needed to reach $50,000 limit 62
Chart 3: Annual payments to new producers resulting from farm reorganizations 63
Chart 4: Cumulative payments to new producers resulting from farm reorganizations 64
Appendix II:
Case Study No. 1—Reorganization Using Multiple Corporations 65
Corporate Case Study—1985 Organizational Structure 66
Corporate Case Study—1986 Organizational Structure 67
Case Study No. 2—Reorganization Showing Investors That Cash Rent Farms 68
Cash Rent Case Study—1985 Organizational Structure 69
Cash Rent Case Study—1986 Organizational Structure 70
Farm Payments—Basic Changes Needed to Avoid Abuse of the $50,000 Payment Limit, GAO Report to the Congressional Requesters, July 1987 71
Hertz, Milton J., Administrator, Agricultural Stabilization and Conservation Service, U.S. Department of Agriculture, Washington, DC, accompanied by Tom VonGarlem and Wayne Mayfield, Assistant Deputy Administrators, State and County Operations, ASCS 149
Prepared statement 151
Recommendations by GAO to the legislation:
First proposed GAO amendment would close a loophole 157
Second amendment clarifies a requirement 157

Page

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Questions for USDA 160
USDA's proposed amendment to section 1001(5) of the Food Security Act of 1985, as amended, with necessary revisions to close loopholes identified by GAO 161
Questions for USDA and supplied answers 164
National Grange, prepared statement, re: Limitation on direct price-support payments made annually to one person 166

PAYMENT LIMITATION PROVISIONS

TUESDAY, JULY 21, 1987

U.S. SENATE, SUBCOMMITTEE ON NUTRITION AND INVESTIGATIONS OF THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,

Washington, DC.

The subcommittee met, pursuant to notice, at 10:07 a.m., in room SR-332, Russell Senate Office Building, Hon. Tom Harkin (chairman of the subcommittee) presiding.

Present or submitting a statement: Senators Harkin and Pryor.

STATEMENT OF HON. TOM HARKIN, A U.S. SENATOR FROM IOWA

Senator HARKIN. The Subcommittee on Nutrition and Investigations will come to order.

This morning the subcommittee is sitting as a Subcommittee on Investigations to take a look at the administration and enforcement of the $50,000 per person payment limitation for farm programs.

We have had per person limits on these programs since 1970, and the record is replete, and I think unequivocally clear, that these programs have had the goal of directing Government assistance to small- and mid-size family farmers. Prior to 1985, few farmers were affected by this limitation; however, with the enactment of the 1985 farm bill, this has changed dramatically. The lower loan rates permitted by the 1985 farm bill, coupled with declining commodity prices, substantially increased the per unit payment coming from the farm program. Not only did this entice more farmers into the farm program, it also greatly increased the number of farmers potentially affected by the payment limitation caps.

For example, the number of persons who qualified for the maximum or near maximum payment in 1983 was 4,306. By 1985, in only 2 years, that number had risen to 28,678, accounting for 22 percent of producer payments. While some of this increase is a result of larger per farm payments, much of the increase is due largely to reorganizations, farm reorganizations, which have no other purpose than to maximize payments by breaking up large farms into smaller parcels, greatly multiplying the number of persons eligible for the maximum payment limitation.

We have had reports from the Secretary of Agriculture, the General Accounting Office, and the Office of the Inspector General, all of whom are here today and will be testifying, and they have demonstrated how easily the payment limit can be avoided by "creating" additional "persons," many of whom have little if any involvement in the farming operation whatsoever.

Personally, I think that what has happened has basically perverted the policy that has been clearly enunciated by this committee and the Committee on Agriculture in the other body, and by both the House and the Senate. However, I think that before Congress considers any legislation in this area that we ought to document it, investigate it, take a look at the nature of the problem and the extent of it and proposals, perhaps, for changing it.

Again I just want to point out that in yesterday morning's paper in a column by Jack Anderson and Dale Van Atta, they pointed out some very interesting figures. They said that, "The General Accounting Office reckons that if the trend continues, the cumulative program costs for 1984–89 would be about $2.3 billion, with some $900 million of that added in 1989 alone."

Well, I will be asking GAO about that to see if that is a correct estimation or not, but if that is the case, we are really going to have to take a serious look at this problem. We have budget reconciliation coming up. We are going to have to make some cuts in agriculture, and as we battle to find those cuts, perhaps this is one area in which the Congress might want to take a look.

As I said before, I think we ought to take a look at the nature and extent of the problem and the proposals for changing it.

I would ask unanimous consent that my statement be made a part of the record in its entirety. I just paraphrased it. Without objection, so ordered.

[The prepared statement of Senator Harkin follows:]

PREPARED OPENING STATEMENT OF HON. TOM HARKIN, A U.S. SENATOR FROM IOWA

Welcome to today's hearing on the administration and enforcement of the $50,000 per person payment limitation for farm programs.

Per person limits on farm program payments have existed since 1970 and have had the traditional goal of directing government assistance to small and mid-size family farmers. Prior to 1985, few farmers were affected by this limitation; however, with the enactment of the 1985 farm bill, this has changed dramatically. The lower loan rates permitted by the 1985 farm bill coupled with declining commodity prices substantially increased the per unit payment coming from the farm program. Not only did this entice more farmers into the farm program, it also greatly increased the number of farmers potentially affected by the payment limitation.

The number of persons who qualified for the maximum or near maximum payment in 1983 was 4,306. By 1985, that number had risen to 28,678, accounting for 22% of producer payments. While some of this increase is a result of larger per farm payments, much of this increase is due largely to reorganizations which have no other purpose than to maximize payments by breaking up large farms into smaller parcels, greatly multiplying the number of persons eligible for the maximum payment limitation.

Reports from the Secretary of Agriculture, the General Accounting Office, and the Inspector General—all of whom we have represented here today—have demonstrated how easily the payment limit can be avoided by "creating" additional "persons," many of whom are distant investors with little real involvement in the farm operation. GAO has estimated that if this baby boom continues through 1990, the cumulative additional cost of these "persons" will be over $3.0 billion. In addition, many of these schemes are of questionable legality, and the Inspector General will be questioned with respect to these enforcement activities.

While many instances of abuse are occurring which clearly subvert the Congressional intent of the payment limitation, it is also true that current USDA regulations have in some cases actually worked against family farmers who wish to help a son or daughter get started in farming.

Personally, I think this perverted policy is a national scandal. However, before Congress proceeds to consider any legislation in this area, I feel it is important to fully document and investigate the exact nature of the problem. That is the purpose of today's hearing.

Senator HARKIN. This morning we have three witnesses, and I am sure they will be accompanied by other individuals.

We will start first with Mr. Robert Beuley, Inspector General, Office of the Inspector General, U.S. Department of Agriculture. Mr. Beuley, if you have anyone else you want to bring up to the table with you, please feel free.

Mr. Beuley, we have your statement, and it will be made a part of the record in its entirety, and if you would care to just basically paraphrase it, summarize it, or highlight it, I would be most appreciative.

STATEMENT OF ROBERT W. BEULEY, INSPECTOR GENERAL, OFFICE OF THE INSPECTOR GENERAL, U.S. DEPARTMENT OF AGRICULTURE, WASHINGTON, DC, ACCOMPANIED BY JAMES EBBITT, ASSISTANT INSPECTOR GENERAL FOR AUDIT; AND JACK LEAVY, REGIONAL INSPECTOR GENERAL FOR AUDIT, U.S. DEPARTMENT OF AGRICULTURE, TEMPLE, TX

Mr. BEULEY. Thank you, Mr. Chairman.

I would like to introduce to my left, Mr. Jim Ebbitt, my Assistant Inspector General for Auditing, and to my right, Jack Leavy, our Regional Inspector General, Southwest Region, who managed the overall nationwide audit.

Mr. Chairman and members of the subcommittee, I am submitting my prepared statement for the record, and I have a few highlights to present.

We are pleased to appear before you today to discuss our audit and investigative activities regarding the Agricultural Stabilization and Conservation Service's [ASCS] Payment Limitation Provisions for the Feed Grain, Rice, Cotton and Wheat Programs. Our audit strategy centered on ASCS program administration and whether controls over payment limitations were sufficient to preclude or detect fraud and abuse. Audit work was performed at the ASCS headquarters, Kansas City Management Office, and 30 counties in 7 States, where we reviewed farming operations for 371 groups having 1,059 "person" determinations. A group was defined as consisting of one or more "persons"—for example, a partnership that may have four people would be considered one group. We have completed 14 investigations since April 1984, and 6 matters are currently under ongoing investigation.

Of the 14 investigations completed, 4 are pending a decision to prosecute by the Department of Justice; 3 cases were not referred to the Department of Justice after further investigation did not disclose a program violation; and the prosecution on the remaining 7 completed investigations was declined by the Department of Justice due to either improper ASCS administrative action, lack of criminal intent, or insufficient evidence of the criminal violation. Of the seven cases that were not prosecuted, ASCS is taking or proposes to take administrative action in at least four of those.

Our audit sample was selected from an eight-State universe which represented about $1.7 billion, or about 41 percent of the nationwide total payments of about $4.1 billion in 1984 deficiency and diversion payments. We used computer analyses to identify those cases where it was likely a "person" determination had been made.

We defined likely cases as those where total payments of over $50,000 went to more than one person at a common mailing address and entities or "persons" that received over $45,000 for the first time in 1984. We then sampled from those cases where it was likely a "person" determination had been made. This resulted in audit work in 30 counties and 7 States, where we reviewed farming operations for 371 groups having 1,059 "person" determinations. These people received $33.5 million in 1984 benefits and, of these, we identified overpayments of $5.8 million for 1984.

Although the sample cases were selected based on 1984 data, once selected, all related operations and pertinent years were reviewed. If the decision for any related entity for any year was incorrect, we considered the impact on payments up to and including 1986.

We questioned 1981 through 1986 payments to 225 persons, totaling about $15.7 million. Projecting these results to the eight-State universe of persons at common mailing addresses and new producers, we estimate that about $60 million in improper payments have been made or approved.

ASCS decisions accounted for, in our opinion, approximately two-thirds of the error cases and questioned payments. Producer noncompliance accounted for the other one-third.

The kinds of conditions that led to the problems we found on the cases were, for example: Farm operating plans were not filed in 44 cases; the farm operating plans were incomplete in 33 cases; the farm operating plans were not followed in 63 cases; changes in farming operations were not substantive and bona fide in 141 cases; contributions were not commensurate with profit shares in 131 cases; financing arrangements not separate and distinct in 99 cases; and custom farming rules were violated in 62 cases.

The number of incorrect cases are duplicated, because there were more than one condition in some cases.

The audit also identified a need to strengthen ASCS monitoring and oversight activities by implementing action to help assure that payment limitation rules are consistently applied by State and county committees; by reemphasizing reviews prior to final payments; by holding producers, employees and committees responsible for their actions; and by implementing a random spot check of compliance with "person" determination rules.

We also made recommendations to redefine a "person" for corporations and partnerships to better preclude avoidance/evasion of the $50,000 limit.

As required, the Secretary reported to Congress on laws and regulations that could be changed to better ensure the fair and reasonable application of payment limitations and eliminate fraud and abuse. This report proposed rule revisions which would treat all farming entities the same, including corporations, limited and general partnerships and trusts. Another proposal would require individuals to make significant contributions of land, cash, or equipment; and management or labor to qualify as a separate person.

These and other proposals, as well as the planned corrective actions by ASCS that they reported to us, should help to minimize the type of abuses we reported.

Subsequent to our nationwide audit we have completed five audits of payment limitation cases based on external requests for information. We questioned in these audits another $3.5 million due to problems similar to those disclosed in our nationwide audit. Two similar audits are currently ongoing. In addition, we have found two large land companies who exceeded the $50,000 limitation by entering into leases requiring the lessees to pay the land companies a percentage of the ASCS payment in addition to the direct payments the companies were already receiving. We are working with ASCS to identify other companies that may be in the same situation.

In our future audit work, we are also planning to focus on some larger farming operations for the 1986–87 payments.

Basically, that concludes my highlights, and if you have questions, Mr. Chairman, we would be glad to answer them.

[The prepared statement of Mr. Beuley follows:]

STATEMENT OF ROBERT W. BEULEY, INSPECTOR GENERAL
OFFICE OF INSPECTOR GENERAL, U.S. DEPARTMENT OF AGRICULTURE

Mr. Chairman and Members of the Committee, we are pleased to appear before you today to discuss our audit and investigative activities regarding the Agricultural Stabilization and Conservation Service's (ASCS) Payment Limitation Provisions for the Feed Grain, Rice, Cotton and Wheat Programs. Our audit strategy centered on ASCS program administration and whether controls over payment limitations were sufficient to preclude or detect fraud or abuse. Audit work was performed at the ASCS National Office, the Kansas City Management Office, and 30 counties in 7 States, where we reviewed farming operations for 371 groups having 1,059 "person" determinations. A group was defined as consisting of one or more "persons"; for example, four partners operating a farm would comprise a group. We have completed 14 investigations since April 1984, and 6 matters are ongoing. Most of the allegations involved the submission of false statements and records to support additional "person" determinations for payment purposes.

Background

Payment limitations were first established by Congress in the Agriculture Act of 1970 (Public Law 91-524) to reduce costs and prevent excessive benefits to producers. The current $50,000 payment limitation began in 1980. The Agriculture and Food Act of 1981 (Public Law 97-98) established the basic guidelines for the farm programs for 1982 through 1985. The Act provides that the Secretary must define the term "person" for payment limitation purposes and prescribe rules as necessary to assure a fair and reasonable application of the limitation. ASCS has defined a "person" as an individual, joint stock company, corporation, association, trust, estate, or other legal entity that:

1. Has a separate and distinct interest in the land or crop.
2. Exercises separate responsibility for the interest described.
3. Is responsible for farming costs related to the interest from a fund or account separate from that of any other individual or entity.

The total program payments, primarily deficiency and diversion payments, for feed grain, rice, upland cotton, and wheat for each of the 1982 through 1986 crop years could not exceed $50,000. The $50,000 payment limitation and the same basic guidelines for defining a "person" were continued for 1986-1990 by the Food Security Act of 1985 (Public Law 99-198).

Audit Objectives

The overall audit objective was to determine whether controls over payment limitations were sufficient to preclude or detect fraud and abuse. Specifically, our objectives were to determine whether:

- Properly completed farm operating plans were submitted when necessary;
- ASCS correctly approved the plans in accordance with payment limitation rules; and
- Controls were sufficient to ensure that farmers complied with their plans.

Our sample was selected from an 8-State universe which represented about $1.7 billion, or about 41 percent, of the nationwide total payments of about $4.1 billion in 1984 deficiency and diversion payments. We used computer analysis to identify those cases where it was likely a "person" determination had been made. We defined likely cases as those where total payments of over $50,000 went to more than one person at a common mailing address and entities or "persons" that received over $45,000 for the first time in 1984. We then sampled from those cases where it was likely a "person" determination had been made. This resulted in audit work in 30 counties in 7 States where we reviewed farming operations for 371 groups having 1,059 "person" determinations that received $33.5 million in benefits.

Audit Results

Improved Administration of Payment Limitation Rules Needed

Our audit found improper or unjustified payments in excess of the payment limitation to 225 "persons" (21 percent of the sampled cases). Overpayments for the 1981-1986 program years to these cases totaled about $15.7 million. Projecting these results to the 8-State universe of "persons" at common addresses and new producers, we estimate that about $60 million in improper payments have been made or approved.

Although the sample was selected based on 1984 data, once selected, all related operations and pertinent years were reviewed. If the decision in any year was incorrect, we considered the impact on payments up to and including 1986.

ASCS decisions accounted for approximately two-thirds of the error cases and questioned payments. Producer noncompliance accounted for the other one-third. The primary cause of improper ASCS decisions was the approval of separate "persons" without sufficient information to make proper determinations; this included incomplete operating plans and the absence of plans. We also found that ASCS employees misinterpreted or did not apply regulations regarding custom farming, commensurate contributions, guaranteed financial arrangements, and bona fide and substantive changes. Farmers were considered primarily at fault when they did not comply with their farm operating plans or they otherwise submitted incorrect information to ASCS in support of their plans. The number and type errors disclosed in the 225 "person" determinations found to be improper are as follows. (Note: The numbers of incorrect cases are duplicated and total more than the 225 since often more than one rule was violated on the same case.)

- Farm Operating Plans Not Filed - 44 cases. An example was a case where no farm operating plans were filed or "person" determinations made for a father and son who each received $50,000 in production adjustment payments as cash-rent tenants on the same farm. Our review disclosed that the son did not own any farming equipment and was not present during the planting or harvesting seasons as he attended college over 135 miles away and later began teaching over 100 miles away.

  Cases like this exemplify the need for obtaining farm operating plans so that County Committees have the information necessary to make correct "person" determinations. Accordingly, we recommended that any increase in "persons" be justified by a

properly completed farm operating plan and that special emphasis be placed on obtaining such plans from new entities. The ASCS response stated that current requirements for submitting farm operating plans had been amended to require filing a farm operating plan if the estimated payment to a "person" is at least $40,000 and for other operations for which the County Committee questions or is not familiar with the source of labor, equipment, management, capital or financing.

- o Farm Operating Plans Incomplete - 33 cases. Examples in this category included such vague statements on joint venture plans as the partners would contribute the capital, equipment, land, labor, and management without showing who or the percentages that would be contributed by each partner. A specific example was the plans for a father and son who were approved as equal partners even though the plans did not show how operations would be financed. We found that all expenses were paid by the father from the same account used to finance his other farming operations. Thus, the father and son were not equal partners entitled to separate $50,000 payment limitations. Instead, the farming operation should have been limited to one "person."

We believe it is imperative that all pertinent information be documented, especially such vital items as individual contribution of capital, equipment, land, labor, and management, including financial and custom farming arrangements when applicable. Accordingly, we recommended that ASCS require all items on the farm operating plan be completed before any action is taken on the plans. The ASCS response stated that for 1987, producers who submit incomplete plans will be required to complete the plans or furnish the needed information before a "person" determination is made.

- o Farm Operating Plans Not Followed - 63 cases. Included in this category are the following examples:
  - Two "persons" each received $50,000 based on a farm operating plan showing they were equal general partners. However, during the year the partnership agreement was changed to a limited partnership. The County Committee was not notified of the change so payments were disbursed in accordance with the plan. Partnership income tax returns for the year showed that one partner's share was 95 percent, while the other's share was 5 percent.
  - A corporation owned by three individuals divided its operation into three corporations. Each submitted separate farm plans that were not followed as the original corporation retained ownership of the equipment and operated all three farms.

In response to our recommendation, ASCS agreed to revise the farm operating plan to incorporate a certification from the producer that the County Committee will be informed of any changes in the operation and that failure to inform the County Committee could result in the "person" being declared ineligible for all program payments.

- Changes in Farming Operations Not Substantive and Bona Fide - 141 cases. Our review identified many cases where producers continue to farm the same land with the same equipment. One example was a producer who formed two corporations with two of his employees. The producer and the corporations were approved as separate entities and received about $150,000 in program payments. The two shareholders (employees) did not contribute any capital for their stock in the corporation and records showed that the two employees continued to receive salaries. At the time of our interview with the two shareholders (employees), they were unaware of their purported share interests in the corporation. This was essentially a "paper" change with no increase in the size of operations, yet it was approved by the County Committee even though the entities continued to farm the same land with the same equipment.

  In December 1986 ASCS defined a substantive change in size as a 20 percent increase or decrease in cropland with crop acreage bases normal for the area. While the 20 percent figure provides a more definitive method by which to determine whether a substantive change occurred, we question the rationale for increasing the number of "persons" when cropland and bases are decreased. A reduction in farming operations should not, in our opinion, result in an increase in "persons" for payment limitation purposes. Further, the 20 percent rule did not address the number of new "persons" or entities that could be increased once the criteria for substantive change in size (20 percent) is met.

  We recommended ASCS tighten procedures to assure that the number of increased persons is commensurate with the amount of land added to the farming operation. We also recommended that ASCS clarify procedures to preclude abuse of rules governing changes in farming operations, particularly where only paper changes are involved to circumvent the payment limitation.

  The ASCS response stated that the Secretary of Agriculture submitted to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry proposed legislation changes in regulations designed to ensure that:
  (a) a decrease in the size of a farming operation does not qualify as a substantial change for the purpose of increasing the number of "persons" on the farm;
  (b) if the "substantial change" in the operation is an increase in the size of the operation, such size increase must bear a reasonable relationship to the number of "persons" being added to the operation; and
  (c) a change from cash to share rent would only serve as justification for the owner of the land to be added as another "person" in the farming operation.
- Contributions Not Commensurate With Profit Shares - 131 cases. An example in this category is a family group consisting of a father, a son, a second son, and son-in-law who were approved for equal 25 percent shares. Their 1985 farm operating plan

showed the individuals would contribute 2 percent of the land, 75 percent of the labor, and 100 percent of management, but it did not identify the individuals who would contribute these resources. A supporting partnership agreement stated that the initial capital of the partnership would be the assets of the father which were being used in his sole proprietorship farming operation. The County Committee approved the plan as submitted and determined that each of the partners would be considered a separate "person" and the four partners received equal payments totaling over $172,000 for 1985. Since the partner contributions were not commensurate, the entity was not entitled to more than one "person" for payment limitation purposes.

In determining commensurate contributions, County Committees were to use the contribution of each "person" for five elements shown on the farm plan (land, labor, equipment, capital, and management). As a rule of thumb the ASCS National Office generally used 20 percent for contributions to each of the five elements and set a value for each "person's" contribution to the individual elements based on his/her actual contribution. For example, a "person" not contributing land would get a zero portion of the 20 percent allowed for that element. However, these guidelines had not been published or disseminated to the field. Therefore, we recommended that detailed written procedures be developed and furnished County Committees to help ensure that program payments are commensurate with contributions of individual members to joint operations. The ASCS response stated that this issue was covered in payment limitation training meetings that were conducted for State office representatives. ASCS issued National Notices to address these issues.

- Financial Arrangements Not Separate and Distinct - 99 cases. An example was two individuals who each received $50,000 as separate "persons" during 1984, but did not have separate operations. Producer A obtained a $100,000 operating loan cosigned by Producer B with all proceeds deposited in one account. Producer B purchased all supplies, seed, fertilizer, etc., and operated the farm as Producer A did not have farm equipment. Producer A claimed wages of $13,000 on his income tax as an employee.

The Code of Federal Regulations (Part 795.7) provides that individuals or other legal entities in joint operations shall not be considered as separate persons unless they are actively engaged in the farming operations of the partnerships or other joint operations. ASCS operating instructions (Handbook 5-CM 22) simply state that each member of a joint operation must actively engage in the farming operation. We noted varying interpretations of what constitutes actively engaged in the farming operation. In many cases "persons" in joint operations were attending school or employed in other jobs, some of which were located in another county or State. In our opinion, the term could or should denote an active participation in day-to-day operations on the farm by individuals, other than landlords, engaged in joint operations.

The ASCS response stated guidelines for defining actively engaged in the farming operation were covered in the report to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry. It contained a proposal that actively engaged in farming be redefined to make it more difficult for a member of an entity to qualify as a separate "person". In order to be considered to be "actively engaged in farming," the member of the entity would have to independently make a significant contribution (determined based upon the total value of the farming operation) of land, cash, or equipment, and management or labor.

- Custom Farming Rules Violation - 62 cases. An example of this problem is a case where the County Committee was not aware that a father provided custom farming services for three other entities in which he had an interest. As a result, overpayments totaling over $200,000 were made for 1984 and 1985. A son, a daughter, and a corporation made up of the father and son were approved as separate "persons." However, we found that the father rented equipment to the son and daughter, including specialized harvesting and fertilizing equipment, and also provided operators for the equipment. Also, the daughter used employees of the father's and son's separate businesses. These custom farming arrangements were not known by the County Committee when they made their separate "person" determination.

Entries on the farm operating plan concerning equipment and labor and custom farming arrangements were often not sufficiently detailed for County Committees to know whether the entities were in compliance with custom farming rules. The form requests information on whether any member of the entity rents or leases equipment to the entity and, if so, to list the contributions of equipment and labor to the entity by individual members. These contributions were usually shown as percentages and did not specify the equipment. The form does not specifically request information about the type and amount of equipment owned or to be leased. Thus, County Committees did not always have sufficient information to determine that the entity had sufficient equipment and labor to farm the operation. Because custom farming is a critical part of payment limitation "person" determinations, we recommended ASCS reemphasize custom farming requirements and require that sufficient information be obtained for County Committees to determine that the entities have or can obtain necessary equipment and labor to farm the operations without violating custom farming rules.

The ASCS response stated that custom farming was an item covered in the payment limitation training meetings. Also, two clarifying National Notices (CM-75 and CM-90) with questions and answers relating to custom farming have been issued. The report to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry also

contained a proposal to lower the percentage trigger level from a 20 percent interest to any interest in the custom farming entity and to remove the exception for custom harvesting and chemical application.

Monitoring and Oversight Need Strengthening

The audit also identified a need to strengthen ASCS monitoring and oversight activities by: (1) implementing action to help assure that payment limitation rules are consistently applied by State and County Committees, (2) holding farmers, employees, and committees accountable for their actions, (3) reemphasizing recent requirements that before issuing final payments, County Committees review all cases where the number of "persons" increased from the previous year, (4) improving the higher level review process, and (5) implementing a nationwide random spot-check of compliance with "person" determination rules.

ASCS responded to our audit recommendations detailing actions it had implemented and those planned with an expected completion date. Recommendations were made in the individual county reports to collect overpayments made to individuals. We are currently analyzing the results of ASCS actions to collect the overpayments.

Changes in Definition of "Person" Needed

The current definition of a "person" needs revision to preclude avoidance/evasion of the $50,000 payment limitation through reorganizations, primarily involving corporations, partnerships, or other legal entities. Most of the reorganization of producers to increase the number of "persons" has been through the formation of corporations, partnerships, and other legal entities. However, in many instances, the same producers continue to farm the same land with the same equipment. Accordingly, we recommended that ASCS provide a more restrictive definition of a "person" in applying the payment limitation.

In response to this audit recommendation ASCS referred to the Secretary's report to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry which proposed legislation governing the application of the payment limitation. Key proposed changes in redefining a "person" in applying the payment limitation are as follows: (1) treating all entities (i.e., corporations, limited partnerships, joint ventures, and other entities and associations) the same, (2) requiring that members of an entity be actively engaged in the farming operation by making a significant contribution of land, cash, or equipment; and management or labor, and (3) attributing payments for the entity to the payment limitation for each member based on the members' ownership interest.

Implementation of these proposed changes would eliminate the advantage to reorganize operations through incorporating or adding members to a joint operation without significantly changing operations.

We believe that proposed changes could be enhanced by specifically requiring that individuals or entities involved in leasing of land, other than the landowner, meet the "actively engaged" requirements of making significant contributions of land, capital or equipment, and either management or labor. Also, if the proposed changes are

implemented, ASCS should provide written guidance to State and county offices in applying the rules. Such guidance should include specifics on the amount of contributions of the five elements necessary for a person to be considered "actively engaged" in the farming operation.

Other Audit Work on Payment Limitation Cases

We also made a limited survey of the application of payment limitation provisions to the Conservation Reserve Program (CRP). Although there is a separate $50,000 limitation applicable to CRP, the same rules applicable to program crops apply. We found that county offices were not obtaining farm operating plans for newly created entities that were approved for CRP contracts. This occurred because of confusion as to when the plans were to be obtained. ASCS' initial instruction stated "person" determinations for CRP were to be based on conditions as of October 1. Some local ASCS officials interpreted this to mean the October after the year of application when payments were made. During the audit, the ASCS National Office issued a notice clarifying that CRP "person" determinations are to be made concurrently with the "person" determination for other program crops. Subsequent to our Nationwide audit we have completed five audits of payment limitation cases based on external requests or information. Questioned payments totaled $3.5 million due to problems similar to those disclosed in our Nationwide audit. Two similar audits are currently ongoing. In addition, we have found two large land companies who exceeded the $50,000 limitation by entering into leases requiring lessees to pay the land companies a percentage of the ASCS payment in addition to direct payments the companies received. We are working with ASCS to identify other companies that may be in the same situation.

We also plan to review the adequacy of ASCS monitoring and oversight activities and to review a sample of the larger payments for 1986 and 1987. As you know, effective for 1987, a new limit of $250,000, made up of the $50,000 limit on deficiency and diversion payments plus a $200,000 limit on disaster payments, marketing loan benefits, and portions of deficiency payments not subject to the $50,000 limitation (Findley Amendments Payments), has been established. We will review ASCS implementation and administration of this new limit.

This concludes my statement, Mr. Chairman. I will be glad to answer any questions.

Senator HARKIN. Thank you very much, Mr. Beuley. That was very concise and straightforward.

Just from reading over the prepared testimony that I had before and that I read last night, and then listening to you again this morning, it seems clear to me that ASCS was doing something wrong.

Now, I am not about to say that they were doing something wrong intentionally, that they deliberately tried to do this, to give bigger payments—but there was something wrong in this mix, and I do not know exactly what.

What I would like to ask you is this question. What was ASCS doing wrong in those specific cases where ASCS had made errors, particularly on those seven which they did not refer for prosecution? As I understand, there were seven?

Mr. BEULEY. No. There were seven that we referred to prosecution that were declined by the Department of Justice; and then they were referred to ASCS for administrative action.

Senator HARKIN. And what happened to them?

Mr. BEULEY. For four cases, ASCS is in the process of evaluating; the other three, I think the determination was made that there was not a violation. Is that what the final determination was?

Mr. EBBITT. Well, ASCS is reviewing all seven of the cases. The Department of Justice indicated that they did not see sufficient evidence there to support a criminal violation. ASCS is reviewing the seven cases to determine from an administrative standpoint if they should seek recovery for the overpayments—or, if they or the producer was at fault.

Senator HARKIN. Do you have any knowledge of why the Justice Department refused prosecution in these cases? What was their stated reason?

Mr. BEULEY. Well, basically, the rationale on some was lack of criminal intent. On other cases, they said it was a lack of good documentation by the ASCS office in the flow of things and some of the confusion as to the way the things were operating. They felt that the cases did not have prosecutive merit. Those are the primary reasons.

Senator HARKIN. "Lack of criminal intent" would be—I would construe that to mean one of these ingenious owners—who could have been a corporation or a company—said, here is the law; they hired some lawyers, and these lawyers said, here is the way you get by that law legally. You set up "persons" that are defined like this under the law, and that way, each "person" can get the $50,000 limit. And they went ahead and did that. Then I assume the Justice Department looked at it and said, well, their intent was not to break the law, but their intent was to use whatever legal means they had of increasing their payments.

Mr. BEULEY. Part of that, Senator, plus also one flaw that we found in the system is that some of the initial plans that were signed off by the people, it was an intent of how they were going to operate; they then made changes afterward, but there was no requirement to come back and tell ASCS.

Now, in one of our recommendations, which ASCS has agreed to implement, they are going to expand the certification and require, if a producer is going to change anything, that they come back into

ASCS to go over that change. Therefore, the producer will not reorganize and so on and so forth during the year without ASCS' knowledge and information.

Senator HARKIN. Can you be any more specific about the four cases that are being reviewed by ASCS? I do not have any specifics on them. Can you give me some idea of what they did?

What was the nature of their bending the law, so to speak?

Mr. EBBITT. Excuse me, Senator. Are you asking about the four cases that are pending, the Department of Justice decisions?

Mr. BEULEY. No; these are the ones declined. If I could, I will provide the details for the record, but a couple of these, Senator, would be like in one situation, the person provided full restitution, and that is one of the reasons the U.S. attorney decided not to prosecute. I would like to provide that for the record if it would be all right.

[The material follows:]

A brief summary of the four cases and subsequent action by ASCS are as follows:

In the first case, ASCS requested our investigation to determine if a New Mexico landowner and his lessee had submitted a fictitious lease agreement to evade the maximum payment limitation provisions. The landowner received maximum benefits on one of his farms, while a tenant received about $10,000 in benefits from a second farm.

We determined that the landowner had paid the utilities used for irrigation of the leased land and had sold wheat which he identified as belonging to the lessee. The landowner said the lessee was his nephew and that he provided him operating assistance in the form of a loan and the use of employees, equipment, and tools.

An Assistant United States Attorney in Albuquerque, declined criminal prosecution due to the lack of criminal intent.

ASCS determined the landowner and the lessee were one person for payment purposes and recovered $12,010.

In the second case, ASCS requested our investigation to determine if a member of an Arizona farming operation, consisting of two partnerships and five trusts, had submitted false information to ASCS to evade the maximum payment limitation.

We determined that a change in the farm operating structure had taken place and that this information had not been reported to ASCS. We also determined that the local ASCS Office had failed to obtain an ASCS form titled, Farm Operating Plan for Payment Limitation Review, from the subject.

The subject claimed the revised lease had not been provided to ASCS due to an oversight. The subject repaid $128,154 to ASCS.

An Assistant United States Attorney, Tucson, declined to prosecute due to a lack of prosecutive appeal since the ASCS office had failed to obtain the farm operating plan and the fact that the subject had repaid ASCS.

The third case was initiated after our audit staff found that four members of a Colorado farming partnership had each received the maximum 1984 ASCS program benefits while Farmers Home Administration (FmHA) records showed that two of the four partners had withdrawn from the partnership effective January 1, 1984.

Our investigation confirmed the ASCS records which showed a four person partnership was formed during 1980; that all four partners signed ASCS contracts to participate in the 1984 program; and that each of the four partners received maximum 1984 ASCS program benefits. FmHA County Office records showed two of the partners had withdrawn from the partnership effective January 1, 1984, in order for the partnership to obtain FmHA loans. We also found that the ASCS County Office had not obtained the required Farm Operating Plan for Payment Limitation Review for the 1984 program.

An Assistant United States Attorney, Denver, declined criminal prosecution in deference to administrative action. The reasons given for the declination were that required program documentation was not obtained by ASCS and the apparent lack of communication between the ASCS and FmHA County Offices. We expect ASCS to initiate administrative action to recover the overpayments.

The fourth case was conducted as a result of an OIG audit which determined that a father and son in Arkansas, who participated in the rice program, had not carried out their farming operations as reported to ASCS.

Our investigation determined that the father and son had each signed up for the 1984 program as independent cash rent operators of different portions of the same farm. The ASCS County Office determined the son, who was a minor, was a separate entity. ASCS had no record of their determination in their file and they could not locate the minutes of the county committee meeting which would have substantiated or explained their basis for making the separate entity determination. The landlord certified on an ASCS Report of Acreage form that the father and son were separate operators. The son hired his father to prepare his rice seedbed. Under the custom hire provisions of the ASCS program the father and son would be considered as one operator. The landlord and the two producers denied that they had conspired to supply false information to ASCS.

Based on our initial report ASCS determined that the father and son should be combined as one farming entity. ASCS has sent a letter to the producers demanding that the $50,000 be repaid.

An Assistant United States Attorney, initially declined criminal prosecution due to a lack of evidence of criminal intent to defraud USDA. In August 1987, we reopened our investigation based on new information provided by ASCS. The results of our supplemental investigation will be presented to the United States Attorney for his consideration.

A subsequent review of case files by my staff disclosed an additional maximum payment limitation case on which prosecution was declined. This case is summarized as follows:

This investigation was conducted as a result of an OIG audit which determined that the owner of three rice farms had provided false statements to ASCS and had manipulated the percentages of ownership of one corporation among his family members to exceed the maximum payment limitation.

ASCS regulations require that if a stockholder owns a controlling interest of more than 50 percent of a corporation, the stockholder and his corporation are considered one entity for maximum payment limitation purposes. Also the stockholder has to certify the amount of stock he owns as of March 1 of each program year on the ASCS form, Farm Operating Plan For Payment Limitation Review.

Our investigation determined that the subject certified to ASCS that he was the sole owner of one corporation; that he and his wife formed and were 50 percent owners of two other corporations; that two of their adult children were the owners of the other 50 percent interest in one corporation; and that two other adult children were the owners of 50 percent interest in the second corporation. As a result the three corporations each received deficiency payments.

We determined that the two corporations which the subject claimed 50 percent interest in were formed for income tax purposes and that the subject had actually maintained 100 percent ownership of one corporation until December 31 so he could claim all of the corporate losses for tax purposes. We also determined that the subject had not reported one $50,000 deficiency payment on his income tax return.

An Assistant United States Attorney, Sacramento, declined to prosecute the subject. The declination was due to the difficulty in proving the subject's intent to defraud USDA. As recommended by the Assistant United States Attorney, the results of this investigation were provided to the Internal Revenue Service for civil tax considerations.

Based on our investigation ASCS determined the subject received an overpayment of $50,472. ASCS recovered the overpayment in 1986 by offset.

Senator HARKIN. Do you know how much money was involved in these four?

Mr. BEULEY. Again, I would like to provide that for the record. It is probably in total somewhere around $500,000 to $600,000, I would think, but I would like to provide that.

Senator HARKIN. All four?

Mr. BEULEY. Well, in total—but I would like to provide that for the record so I can give you an accurate figure.

Senator HARKIN. I would like to see that.

[The material follows:]

The four cases involved questioned payments which totaled $290,164. Of that amount, ASCS has recovered $140,164; has made demand on the producer for $50,000; and is still considering administrative action regarding $100,000. In the fifth case mentioned ASCS recovered $50,472.

Senator HARKIN. Tell me again about in your review, did you uncover instances, or how many did you uncover, where you suspected that fraudulent activities may have occurred to create these extra "persons"? Were there any such things that you found where there was actually really fraudulent activity, that you thought was fraudulent?

Mr. BEULEY. Of the 225 "persons" determinations found in error we figured that about two-thirds of those we could lay to improper actions or errors by ASCS. The other one-third, approximately 70 cases, it appeared to us that either the producer did not follow through with the plan or provided incorrect information. And those one-third, the 70, ASCS is going back now and reviewing each one of those and referring things to us.

Now, out of that, I think, as I said, we have 20 cases—6 of them, we have ongoing; 4 of them are with Department of Justice where they are considering prosecution at this point; 3 of them, we determined after further review there was no criminal violation; and the other 7, Justice declined, and ASCS is going through these cases now for possible administrative action.

Senator HARKIN. In your opinion, will the proposed revisions make the payment limit rules less complex and easier to administer?

Mr. BEULEY. I believe so, Senator. The important point there is that the new rules will clarify a lot of the points that the county office people can now use to clarify a lot of these reorganizations and definitions of a "person", and what must be contributed, and so on. I think that was part of the confusion in the past.

So I would think that the proposed legislation, if passed, and the recommendations as ASCS proposes to implement them, should strengthen the controls and make it a lot easier for the county people to make sound decisions.

Senator HARKIN. So are you saying the legislation is necessary, then?

Mr. BEULEY. Yes.

Senator HARKIN. I would note that our distinguished colleague from the State of Arkansas is here, Senator Pryor. We have just had the witnesses here from the Inspector General's Office, who have been conducting an investigation since 1985 into these payment limitations.

As you know, the Department of Agriculture has made some recommendations for legislation, and we will be taking a look at that. This subcommittee is just sitting as an investigatory subcommittee to see what they have done and what they found out.

I would recognize the distinguished Senator from Arkansas for a statement or questions.

STATEMENT OF HON. DAVID H. PRYOR, A U.S. SENATOR FROM ARKANSAS

Senator PRYOR. Well, Mr. Chairman, I thank you.

I really do not have a statement, but a couple of observations.

As all of you gentlemen here today know, we have had a lot of problems in our own State of Arkansas with some of these cases. And I must say this—and certainly, Mr. Chairman, I know I speak

for all of us on the full committee, not only the subcommittee—none of us want to see fraud committed, but there has been a great body of misunderstanding out there among the many farmers who participate in the program. A lot of this has been because, in my opinion, ASCS on the local level has not gotten the mandate or the policy goals or mission of the program from the Washington scene, and they have operated almost in the dark. One county is different from the next. You could go 23 miles down the road to the next county seat, or the next ASCS office, and get two different interpretations.

So a lot of the problem has been because of pure misunderstanding in the implementation of an extremely complex concept.

I do have a question, if I might. Under the reorganization plan, do you look for more program participation or less? Do you see this encouraging more of the farmers to go into the program, or to stay out of the programs?

Mr. BEULEY. I do not know what the impact would be as far as more going in. I would say that there would be less reorganizations, and they would stay where they are organized right now. I would think it would be simpler for a lot of them, once the county offices are very clear on the rules and the regulations—and I think a lot of what you pointed out was true; our audit pointed out they needed more training, they needed to change the handbooks—and this will make it easier or clearer for the participants to understand all the rules and to understand all the things they have to fill out.

But as far as whether there will be more or less, I really do not have an estimate on that, sir. I think there would be less reorganizations.

Senator PRYOR. Yes, fewer reorganizations. All right. What about this, on page 2 of your prepared statement: "ASCS decisions accounted for approximately two-thirds of the error cases and questioned payments. Producer noncompliance accounted for the other one-third. The primary cause of improper ASCS decisions was the approval of separate persons without sufficient information to make proper determinations; this included incomplete operating plans and the absence of plans. We also found ASCS employees misinterpreted or did not apply regulations regarding custom farming, commensurate contributions, guaranteed financial arrangements, and bona fide and substantive changes."

This, of course, is from the GAO report——

Mr. BEULEY. That is from our report, sir.

Senator PRYOR. Yes, that is right. This is from the Inspector General's Office of USDA.

Is your plan going to improve this?

Mr. BEULEY. If ASCS implements the recommendations, which they said they will do, and some they have already implemented.

Senator PRYOR. Are you satisfied with the coordination and the flow of information between your office, the Inspector General's Office, and the ASCS? Are you satisfied with that relationship?

Mr. BEULEY. Yes, I think there is a good relationship there.

Senator PRYOR. Let us assume there is a good relationship. Then, are you satisfied with the communication that goes on between these two functions?

Mr. BEULEY. I have no reason to be dissatisfied with it. We have been writing back and forth and talking quite often on the problems and what they are planning to do about it, so I do not really have a problem that they are not communicating with us.

We have problems from time to time—for example, the one-third that they are doing further detailed review on to determine whether they are going to bill or not, we will be looking at ASCS support on that, and we may not be in total agreement with it.

Senator PRYOR. I worked on a case, and I think I called you, in the Temple, Texas office about it. Then I talked to the Little Rock ASC office. Then I talked to the Washington office. I found that in that particular case, no one knew what the other was doing—or, if there was mailing of information or documents required, it did not take 2 or 3 days, as one would suppose, to receive and stamp in the information and put it into this farmer's file—it took weeks. In the meantime, that poor farmer was out there, hanging on literally by his fingernails, trying to figure out if he was supposed to go out and plant or not plant, or borrow money or not borrow money.

This case went on, as I recall, well over a year. He never knew a decision; he never had a decision. There was no coordinated effort.

What is your plan going to do to remedy this?

Mr. BEULEY. Well, the recommendations that we proposed are, first of all, if you change legislation, that will clarify a lot of the "person" determination, reorganization part, which should make things easier from that point of view.

They have also implemented changes in their handbooks to give better guidelines. They have provided training courses out there in the counties, to better define what is going on and how to do specific tasks.

Now, as far as how effective that is going to be, again, that is probably a question you need to ask ASCS, because they have the prime responsibility from the headquarters to deal with the counties. We will be out there in different audits, looking at it, and if we find a problem, we will be raising the issues again to ASCS headquarters. But if they follow through with everything proposed, I think it should be much more effective than it has been in the past.

Senator PRYOR. Thank you, Mr. Chairman. I may have a another question. Thank you.

Senator HARKIN. Thank you, Senator Pryor.

I just have a couple of closing comments. One, as I understand it from page 2 of your prepared statement, you say that "There was a 21 percent error rate by ASCS in the sample drawn." That seems to me to be very, very high. You say 14 percent was due to ASCS decisions and 7 percent due to producer noncompliance.

Again, I do not know what ASCS has been doing wrong, but since I chair the Subcommittee on Nutrition and Investigations on foodstamps, a State is allowed 5 percent error rate; if they get above 5 percent, sanctions are imposed on the foodstamp program in that State. Here, we have a 21 percent error rate in a program that is not going to the neediest people of this country.

Don't you find that that is kind of high? You are an accountant.

Mr. BEULEY. Yes, sir. Mr. Chairman, let me put this in perspective. The 21 percent is the error rate in our sample cases for the

universe, which is a restricted universe, that we looked at. But also, to put it in perspective, of the 30 counties that we looked at and the $15.7 million of actual errors that we found, 3 of the counties represent 69 percent of that amount as far as the dollars.

So even though there is a high error rate, there are some particular counties that need more scrutiny and oversight and training than others.

Senator HARKIN. Mr. Leavy, you were the one in charge, basically, of this report, right?

Mr. LEAVY. Yes, Senator.

Senator HARKIN. Let me just read this last sentence where you say, "In all, the questioned payments amounted to about $15.7 million to 225 persons of the 1,059 tested, or 21 percent error rate. Based on our statistical projection, we estimate that $60 million in improper payments were made in the 8-State universe."

Mr. LEAVY. Correct, yes.

Senator HARKIN. So, $60 million is what you are projecting from your sample. Have you made a projection nationally?

Mr. LEAVY. There were approximately 2,000 addresses that we sampled where two checks went to the same address. We went to that address and checked and reviewed the operations of all entities connected with that address for several years. And in about 371 of them, we found our $15.7 million.

The $60 million represents that if you checked out the rest of the approximately 1,600 addresses, you would find an additional $44 million, just of that limited universe of new producers and producers where multiple payments went to the same address.

Mr. BEULEY. That is only an eight-State area. We did not project for the total country, because we would have to take a different sample to project for the country.

Senator HARKIN. Were you surprised at these findings, Mr. Leavy?

Mr. LEAVY. Well, yes. To put them maybe in more perspective, 1984 was our sample year. That was what we based the data on, and there is some universe data there that we can project with some precision. There was $148 million in our universe in those eight States, and from that, we reviewed the operations of $33.5 million, and in that $33.5 million, we found $5.8 million in error. This would project out to about $23 million of the $148 million.

Mr. BEULEY. We were not surprised at how high it was. But again, we were gearing in on this particular view to look for person determinations which we felt would be the most significant error if an error was made, and also to try from the sampling to determine whether we had systemic problems. And I think this audit has proven that there are systemic problems in the system, there are some needs for legislative changes, and if the legislative changes are made, and the actions that we recommended are followed through on, we think that should go a long way in controlling and better making this program more effective.

Senator HARKIN. Senator Pryor, do you have followup questions?

Senator PRYOR. If I could ask a couple more. Mr. Beuley, let me ask you this. Your office claims that the payment limitation rules have not changed, I believe, since 1970.

Mr. BEULEY. I think that was the primary rules.

Senator PRYOR. We did not change the rules or——

Mr. EBBITT. I am sorry. The payment limitation rules have been in effect since 1970.

Senator PRYOR. So we did not change, for example, in 1985 the definition of "person", did we, in the ag bill?

Mr. BEULEY. No. That is correct.

Mr. EBBITT. Correct.

Senator PRYOR. I know when you talk about problem counties, you may think of Jefferson County, Arkansas, which is a rather large agriculture county. You audited Jefferson County in 1984 and 1985. It is my understanding you found no violations. However, you came back in 1986, and you found massive violations. We had not changed the rules, we had not changed the law. ASCS, however, had changed the interpretation of that law. Am I correct?

Mr. BEULEY. Can you comment, Jack, on the prior audit?

Mr. LEAVY. I think in the prior audit——

Senator PRYOR. That is "p-r-i-o-r", not "P-r-y-o-r", please. I am being audited by enough people already. [Laughter.]

Mr. LEAVY. In the audit we did previous to this one, we reviewed two counties in Arkansas and looked, I think, at a total of 11 operations. In that audit we selected our sample differently from the way we did it this time—it was based primarily on corporate farms. We were at that time zeroing in on that phase of it. And when we came back in 1985 to review, many more reorganizations had taken place than had occurred in the past. Even in that audit we had a few recommendations concerning such things as the need to obtain farm operating plans and things like that. But the extent of the problems were more severe in 1985, and there was much more volume of activity during our latest review because of farmers reorganizing their operations.

Mr. BEULEY. But we can provide you for the record whether there were any errors in the prior audit dealing with Jefferson County. I do not know at this point whether there were.

[The material follows:]

The audit covered operations at the State Office and in Chicot and Jefferson Counties. We reported that administrative controls were not functioning as intended because the required number of payment limitation determination cases were not submitted to the next higher management level for review. We also reported that producers had not updated and certified the currency of existing farm plans or filed new annual plans when required. (This condition existed in both counties.)

Program payments of $47,485.40 were questioned in Jefferson County because the interest of two partnerships were different from what ASCS had been informed.

Senator PRYOR. Well, I still maintain—and I do not know if my colleague from Iowa is finding the same thing—but ASCS pretty well changed the interpretation beginning in 1986. They changed the interpretation of the law and threw the farmers into a quandary.

My point is this. Tell the farmers the rules. Tell the farmers the rules; they will comply with them. That is my only message.

Senator HARKIN [conferring with staff]. Counsel just had an interesting question, Senator Pryor.

Senator PRYOR. Why don't you ask it? I would like to shift gears here.

Senator HARKIN. I just wondered why in one county, which I was unaware of, there was this huge increase. Do you know from your investigations if anything took place; like were there ads in newspapers advertising farmers to reorganize. Was there an accounting firm or a lawyer down there advertising? Was there something like that that was getting farmers prodded into looking at this?

Mr. BEULEY. Jack, are you aware of any of that?

Mr. LEAVY. Not in Arkansas counties. I think that has happened in some States and counties. In the Arkansas counties, circumstances contributing to the problem were higher payments and farmers reaching the same payment level quicker which resulted in more farm reorganizations taking place. Overpayments occurred in many cases because State and county officials interpreted the addition of additional persons as qualifying in and of itself as additional "persons" for $50,000 payment limitations purposes.

Senator HARKIN. If you have nothing else, I am going to call GAO.

Senator PRYOR. Thank you, Mr. Chairman.

Mr. BEULEY. Thank you, Mr. Chairman.

Senator HARKIN. Thank you very much for your time and your presentation.

Next we call John Harman, Associate Director, General Accounting Office. And I understand he is accompanied by Edward Zadjura, Project Manager, and Cliff Fowler, Group Director.

Just to make sure we keep all our players straight, we just heard testimony from the Office of Inspector General of the Department of Agriculture. We now have testimony from the General Accounting Office of the Federal Government on farm reorganizations and their impact on USDA payments.

We have a copy of your prepared testimony, Mr. Harman. It will be made a part of the record in its entirety.

Again, I would ask you to introduce the individuals who are with you for the record, and I understand you have some charts to show us.

Mr. HARMAN. Yes, Mr. Chairman.

Senator HARKIN. So Mr. Harman, if you could go ahead and just summarize or highlight your prepared testimony, with your charts, I would appreciate it.

Senator PRYOR. Mr. Chairman, before these witnesses proceed, I would like to compliment them. I can tell they are professional testifiers. They all brought their own nameplates. I think that ought to be mandated in this committee. I want to compliment the GAO. [Laughter.]

Mr. HARMAN. And if you will notice, Senator Pryor, it is on both sides, so we will remember who we are.

Senator PRYOR. We need that same type; we sometimes need to know who we are around here. Thank you. [Laughter.]

Senator HARKIN. Thank you.

Mr. Harman, go ahead.

STATEMENT OF JOHN W. HARMAN, ASSOCIATE DIRECTOR, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY EDWARD M. ZADJURA, PROJECT MANAGER, AND CLIFF FOWLER, GROUP DIRECTOR

Mr. HARMAN. Thank you, Mr. Chairman.

On my left is Cliff Fowler, who is our Group Director in charge of all our work on crop assistance programs; and on my right is Mr. Edward Zadjura, who is the Project Manager for this particular assignment and will be assisting me today in this testimony.

We are pleased to be here today to discuss our work on farm reorganizations related to the $50,000 per person payment limitation. Our work focused on first, identifying the scope and cost of these reorganizations and the methods used to avoid the payment limit; secondly, we were reviewing USDA's proposed changes to tighten the limitation and its process for determining whether reorganizations were proper—very similar to what the IG was doing, except on a smaller scale.

In terms of scope and cost, we identified an increasing trend in reorganizations from 1984 through 1986 that may have been related to the $50,000 payment limit. These reorganizations added almost 9,000 new persons to USDA payment rolls between 1984 and 1986 at an additional cost of some $328 million. We estimate that should the trend in farm reorganizations continue, reorganizations since 1984 could be adding almost $900 million annually to program costs by 1989. Cumulative costs for the 6-year period, 1984 to 1989, could approach $2.3 billion, and another $900 million would be added in 1990, which is the last year covered by the Food Security Act of 1985.

Even if we were to assume that no new reorganizations take place after 1987, the cumulative costs of reorganizations that took place from 1984 to 1987 would be about $1.7 billion through 1989 and $2.1 billion through 1990.

Senator HARKIN. Where did you have that in your testimony just so I can mark that? What page are you on?

[See page 51 of the prepared testimony.]

Mr. HARMAN. Well, I am reading from a summary.

Senator HARKIN. All right. Actually, I just found it right now. Go ahead.

Mr. HARMAN. Stated another way, the costs for the last 3 years of the current farm bill, 1988 to 1990, would be between $1.3 billion if you assume that there are no new reorganizations after 1987, and $2.4 billion if you assume that there will be reorganizations after 1987.

Senator HARKIN. Can I interject here? Is that total, or is that over the $50,000 limit?

Mr. HARMAN. That is new payments, payments to new persons created as a result of some of the methods I will be talking about in a few moments. It is additional payments that would occur because of that. It is not necessarily over the $50,000.

Senator HARKIN. OK.

Mr. HARMAN. What we found is that it is relatively easy and legal for a producer to reorganize to avoid the limit.

The two areas of primary concern are the formation of corporations and the renting of farmland for cash by individuals, partnerships, or joint ventures with a large number of participants.

At this time, Mr. Chairman, I would like to pause for a few moments and have Mr. Ed Zadjura of my staff present two case studies that demonstrate how these types of reorganizations have been used to avoid the payment limitation and obtain multiple payments.

[The case study No. 1 and No. 2 can be found on pages 65 to 70.]

Mr. ZADJURA. We will be showing the charts for yourself Senator, but they are also contained at the back of the copies of the prepared testimony, for anybody in the audience.

Our first case study, Mr. Chairman, shows how a farming operation can be reorganized to take advantage of a loophole in the legislation that allows the creation of legal or paper entities such as a corporation. Such entities qualify for a $50,000 payment limitation as long as no stockholder owns or controls more than 50 percent of the entity. As a result, two persons who each are already receiving the maximum $50,000 payment can reorganize their farm to add a corporation that also receives $50,000. In effect, you have two persons now receiving three payments.

As shown on this first chart, in 1985, six family members—a father, his six adult sons, and his adult daughter—formed a joint venture to farm.

Senator HARKIN. Is this a real case?

Mr. ZADJURA. This is a real case, sir. Both of them are.

Under USDA regulations, each individual member in the venture qualified as a "person" for payment limitation purposes, with an individual $50,000 payment limit, for a total of $300,000 for all six members of the venture.

In 1986, as our second chart will show, the family reorganized into a new joint venture made up of the same 6 persons as in 1985, plus 15 corporations that they formed. Each of the 15 corporations is owned on a 50–50 basis by 2 of the family members and as such complies with USDA regulations relating to the ownership of corporations.

As a result, each of the 6 individuals and 15 corporations qualified as "persons" for payment limitation purposes, and received a total of $1,050,000 for all 21 "persons". Between 1985 and 1986, Mr. Chairman, the cost to the Government on this farming operation increased by $750,000 despite the payment limitation.

Senator HARKIN. So it went from $300,000——

Mr. ZADJURA. For six "persons", yes.

Senator HARKIN [continuing]. To $1,050,000 for how many "persons"?

Mr. ZADJURA. For 6 real, living bodies and 15 corporations or, under the regulations, 21 "persons".

Senator HARKIN. Let me see if I understand this correctly. Father "A" formed a corporation with son "B".

Mr. ZADJURA. Yes.

Senator HARKIN. Father "A" formed a corporation with son "C".

Mr. ZADJURA. Yes.

Senator HARKIN. Father "A" formed a corporation with son "D", son "E" and daughter "F".

Mr. ZADJURA. That is correct.

Senator HARKIN. Then son "B" formed a corporation with son "C", son "D", son "E", and daughter "F", and then on down the line.

Mr. ZADJURA. With his brothers and sister, yes, sir.

Senator HARKIN. I see.

Mr. ZADJURA. And each one of those corporations received $50,000.

Senator HARKIN. Each one of those little triangles on the chart there.

Mr. ZADJURA. Yes—and the 6 individuals also received $50,000; so, 6 living, breathing "persons" turned into 21 "persons" for payment limit purposes.

Senator HARKIN. Let us take this middle corporation here, "B and E, Incorporated", right in the dead center there. It got $50,000.

Mr. ZADJURA. It got $50,000.

Senator HARKIN. Where did it go? Who got that $50,000? Does anybody know?

Mr. ZADJURA. Son "B" and son "E" split it; they are 50 percent owners. But under current law, there is no attribution of a payment to a corporation to the individual who owns it. So that payment does not count against their $50,000 limit.

Senator PRYOR. Is this legal?

Mr. ZADJURA. This is legal, sir, yes.

Senator HARKIN. Did they have to split it 50–50?

Mr. ZADJURA. No one can own more than 50 percent, or then the corporation and the person who owns majority interest is combined. Three persons, for example, could own 33 percent each of this company. But if one person owns 51 percent, they would be the majority owner, and they would be rolled together. In this case, they were all drawn up, they were incorporated, so that everybody owned exactly 50 percent.

Senator HARKIN. So, what was the total to father "A"? He got what?

Mr. ZADJURA. Well, if my math is OK, you divide $1,050,000 by 6; I believe it is $175,000—is what he really got.

Senator HARKIN. Five 25's and one 50, that is right, $175,000—each one of them got $175,000.

Mr. ZADJURA. That is right.

Senator HARKIN. Is this confidential; who are they? Or is this open?

Senator PRYOR. It is an Iowa family. [Laughter.]

You have got to be from Iowa to be ingenious enough to think this up.

Mr. ZADJURA. Not really. There are a lot of ingenious people like this around the country.

Senator HARKIN. It is pretty ingenious.

Is this a real farm?

Mr. ZADJURA. Oh, yes. This is absolutely a real farm, it is a real case, they are 6 real people—15 corporations.

We uncovered this case as part of our random sample, so it is a random chance that we picked this particular one. We know of

other cases. As such, I think we would prefer, since they were just randomly selected, not to reveal their names.

Senator HARKIN. OK, fine. I did not know if that was public knowledge or not.

Senator PRYOR. Mr. Chairman, I think this situation is atrocious.

Senator HARKIN. It is just awful.

Senator PRYOR. I am not here to in any way defend it. I would like to say that I also think that this type of situation hurts 99 percent of the farmers and the image of farmers—and I am applauding you, GAO, for bringing this to our attention, because we have got to correct this. This is just horrible.

Senator HARKIN. Yes, this is just awful.

Mr. ZADJURA. That is correct, Senator. Most farmers are nowhere near this limit, and changes or timing would not affect them.

Mr. HARMAN. And as we will discuss later, most of these changes we are talking about will not affect the large, large majority of the farmers that are out there.

Senator HARKIN. We have a vote; however you have another example, you told me.

Mr. ZADJURA. Yes, sir.

Senator HARKIN. Why don't we just recess and then come back. The subcommittee will stand in recess.

[Short recess.]

Senator HARKIN. The subcommittee will resume its hearing, an investigation into the overpayments on the $50,000 payment limitation. When the subcommittee recessed, we were hearing testimony from the General Accounting Office. We had just gone through one case study involving a family and how they had set up a number of corporations, and I believe Mr. Zadjura was going to go through another example.

Mr. ZADJURA. That is correct.

Senator HARKIN. Please proceed.

Mr. ZADJURA. Our second case study shows how investors with little or no active farming interest of their own can take advantage of USDA's definition of what constitutes a "person" actively engaged in farming.

Under the regulations, an investor who owns no farmland, no equipment or farm building and does not actually work on the land but has the personal resources to finance or to obtain bank financing for operating costs, can qualify for payments.

As shown on our first chart, in 1985 a subsidiary cash-leased 6,660 acres of farmland from its parent company and hired a management company to run its farm operation. Under this organizational structure, only the subsidiary as operator of the farm could qualify as a "person" for payment limitation purposes and receive up to $50,000 in payments.

In 1986, as shown on our second chart, the same farmland was subleased by the subsidiary to the management company that it had hired in 1985. The management company in turn subdivided the 6,660 acres into parcels of about 238 acres each and subleased those to 28 separate investors under individual cash rental agreements. The investors supplied operating capital; they leased equipment; they subcontracted for labor and hired a farm manager. Sev-

eral of these investors lived thousands of miles away from the farm, and two of them are minor children 10 years of age.

Under USDA regulations, these 28 investors each qualify as a "person" for payment limitation purposes and can receive up to $50,000 in payments, or a total of $1.4 million for the 28 "persons".

Each of the investors hit the limit and did in fact receive the $1.4 million, as compared to $50,000 under the 1985 organizational structure.

I would also like to point out, Mr. Chairman, that under current rules, both of these operations would also qualify as "multiple persons" with regard to the new $250,000 payment limit that was passed by Congress as part of the continuing resolution for 1987.

Senator HARKIN. I am sorry. Say that again.

Mr. ZADJURA. Under current USDA rules, both of these organizations are also "multiple persons" with regard to the new $250,000 cap that was put on the marketing loan in Findlay payments as part of the 1987 continuing resolution.

So there is a separate limit for the marketing and Findlay payments of $200,000 on and above the $50,000; they also qualify for multiple payments under that provision.

Senator HARKIN. So how much did this outfit get under that scheme?

Mr. ZADJURA. This outfit got another $660,000, I believe, under that, in marketing loan payments.

Senator HARKIN. So they got $1.4 million in deficiency payments.

Mr. ZADJURA. In deficiency and diversion, and $660,000 approximately in marketing loan payments.

Senator HARKIN. Well, how did they get $660,000 in marketing loan payments if there was a limit of $250,000?

Mr. ZADJURA. Well, they are 28 separate "persons". They could have gotten 28 payments of up to $250,000.

Senator HARKIN. I see. So they got the max——

Mr. ZADJURA. They got the max under deficiency and diversion, but they did not get the max under the marketing loan payments. They just got, I think, about $24,000 apiece.

Senator HARKIN. But they could have.

Mr. ZADJURA. They could have, yes, sir.

Senator HARKIN. Let me understand. In 1985, this landowner at the top had a subsidiary that ran this farm of 6,660 acres.

Mr. ZADJURA. That is correct.

Senator HARKIN. The subsidiary hired a management corporation to run the farm.

Mr. ZADJURA. They just ran the farm on a day-to-day basis, yes.

Senator HARKIN. Do you know how many people ran the farm? Do you have any idea?

Mr. ZADJURA. No. It was all hired labor by the management company. I am not sure exactly.

Senator HARKIN. What crops did they plant, do you know?

Mr. ZADJURA. It is irrigated cotton. It is in California—which is why the acreage is so low to hit the limit.

Senator HARKIN. They also got federally subsidized water, then.

Mr. ZADJURA. Probably. And they are probably "multiple persons" for that, too.

Senator HARKIN. Do we have any way of finding that out? You did not look into that, though?

Mr. ZADJURA. We did not look into that, but I am sure they got federally subsidized water, knowing where they are at.

Senator HARKIN. We ought to take a look at that, too.

But this was 1985. Then, in 1986, they restructured.

Mr. ZADJURA. They restructured it, that is right.

Senator HARKIN. And then they became 28 investors, and they broke it up into 200 38-acre parcels.

Mr. ZADJURA. Yes.

Senator HARKIN. So those little blocks along the bottom, instead of 5, there should be 28 of those?

Mr. ZADJURA. Yes. The middle one represents numbers 3 to 26, because we ran out of space.

Senator HARKIN. Let us take block 1, investor 1.

[See page 70, Appendix II, Cash Rent Case Study—1986 Organizational Structure.]

Mr. ZADJURA. Yes, sir.

Senator HARKIN. The management corporation found this individual—and you said one of them was a 10-year-old child?

Mr. ZADJURA. Two of them were 10-year-old children, yes; they are trusts for 10-year-old children.

Senator HARKIN. So what they did is they leased this 238 acres from the management corporation.

Mr. ZADJURA. That is right.

Senator HARKIN. And the management corporation did all the work.

Mr. ZADJURA. Yes. One law firm associated with the management company drew up all 28 leases; they drew up all the subcontracts with the laborers. They drew up all the equipment leases. By coincidence, these 28 people—some of which, like I said, lived thousands of miles away—signed all these leases on the same date in order to get under the program. But they would have you believe this was done individually rather than collectively.

Senator HARKIN. They all signed them on the same date?

Mr. ZADJURA. Yes.

Senator HARKIN. Were any foreigners involved?

Mr. ZADJURA. I do not believe there are any foreigners on this, no, sir.

Senator HARKIN. Anybody living in other countries?

Mr. ZADJURA. Either in this case or one very closely related that we did not use as an example, there is somebody living in Australia; and we have seen other cases with people living in France. And of course, in a prior report, we reported on payments going to Pakistan.

Senator HARKIN. Let me ask you about this landowner and this subsidiary. Why does the landowner have a subsidiary? I do not understand why there is a subsidiary.

Mr. ZADJURA. The landowner is a major U.S. insurance company, and they have a subsidiary that runs all their real estate holding operations.

Senator HARKIN. Who is this? Is this confidential?

Mr. ZADJURA. Well, it is Prudential Insurance Company, which is one of the large landholders that USDA referred to that they have also seen.

Senator HARKIN. So this is Prudential Insurance at the top.

Mr. ZADJURA. Right.

Senator HARKIN. Who is the subsidiary?

Mr. ZADJURA. It is called PIC Realty—Prudential Insurance Corporation Realty.

Senator HARKIN. So they do the realty work for Prudential.

Mr. ZADJURA. Yes.

Senator HARKIN. And who is the management corporation?

Mr. ZADJURA. The management corporation is an individual and some of his family members in California. I do not remember his name offhand. It is a small operation, a couple of people.

Senator HARKIN. Are any of them investors in this?

Mr. ZADJURA. As best we can tell from some legal documents we have seen, apparently three or four of the persons who own the management company, or their family members, are involved as lessees here, yes. And the son of the owner of the management company is the hired farm manager.

Senator HARKIN. Wait a minute. The son of the——

Mr. ZADJURA. The management company set up all the arrangements, but then the manager that these people hire to farm the land cannot be the same management company because of some ASCS rules. So they had to hire an individual. All 28 of these individuals happened to hire the same person to be the day-to-day farm manager. It is the son of the man who owns the management company.

Senator HARKIN. Incredible.

How much actual cash did each one of these investors put up? There are 28 investors; how much did they put up?

Mr. ZADJURA. Their cash came from a loan on the cotton; the local cotton gin gave them a loan prior to the season for the crop they would be growing, secured by the crop.

So out-of-pocket expenses, other than probably attorney fees or something, were very small. The money was basically advanced to them by the local cotton gin.

Senator HARKIN. So they got advanced the money to lease this land.

Mr. ZADJURA. To lease the land, to lease the equipment, yes, sir.

Senator HARKIN. So it did not really cost them anything out of pocket.

Mr. ZADJURA. The way it was set up, their loan from the cotton gin is paid to them in increments pretty closely related to the times they have to make payments on the leases and the land rents and payments like that.

We have seen cases, Senator, where the banks have loaned them the money on the promise of them getting a government payment, effectively, their $50,000 payment. In this case that was not done, but we have seen other cases where it was done.

Senator HARKIN. Do you have anything else you want to add? I am sorry to interrupt, but I just wanted to make sure that this was clear. Do you have anything else on these or any other cases that you have?

81-879 - 88 - 2

Mr. ZADJURA. Well, we have seen similar cases. These two particular cases are, just by coincidence, irrigated cotton. We have seen similar cases for rice farms and some wheat and some corn farms in all different parts of the country.

Senator HARKIN. Is there a limitation on subsidized water? Are there limits? Does anyone know?

Mr. ZADJURA. Yes. And there has been some recent activity on that. They were going to change the requirements and make it tighter, and then there have been some rules. There are some restrictions on that.

Senator HARKIN. I guess this is out of your realm, but I am just thinking out loud that if we have this cotton farm that is getting subsidized Federal water beyond what, perhaps, they ought to be getting, plus they are getting this kind of a scheme, it would seem to me that that would compete kind of unfairly against dry land cotton farmers who do not have all that kind of wherewithal. It would seem to be rather uncompetitive to me. Maybe somebody could straighten me out on that at some point.

I apologize Senator Pryor. The way I am operating here, if you want to interject or ask any questions about this example or anything, please feel free to at any point.

Senator PRYOR. Once again, I do not think anyone can defend these two examples that the GAO has brought to us this morning. I certainly cannot.

I think many of our farmers are very angry about it. All their friends think they are all out here, dividing up into minicorporations, although most of them are not.

Did the study that you prepared for us build in a presumption of an increase in reorganization over the next 3 years of the farm bill?

Mr. ZADJURA. No, we did not. We used the trend in actual reorganizations we saw from 1984 to 1986 cases. We used the weighted average trend and projected that out for the outyears.

Senator PRYOR. Did you build into or factor into the end results or the bottom line of your study that most farmers would be receiving maximum deficiency payments?

Mr. ZADJURA. Yes. Our assumption for, actually, all the crops, but for the four major crops—cotton, rice, wheat, and corn—was that he would receive the maximum deficiency payment.

Senator PRYOR. The maximum.

Mr. ZADJURA. Yes.

Senator PRYOR. Did your study figure in increased yields per farm?

Mr. ZADJURA. We used the program yield for the outyears, which reflects the changes that have been made in the 1985 Farm Act.

Senator PRYOR. Because I know what we attempted to do in the 1985 farm bill, and that was sort of to freeze the yields, and I did not know whether you built in escalating yields or not.

Mr. ZADJURA. No. We used the program yields from the farm bill or whatever adjustments the Department had to make, if any, to it. And in fact, for some crops, that lowered the yields, I think, initially, from what they had been paid under in prior years.

Senator PRYOR. I have not had an opportunity to read in detail the GAO study, but did you see where ASCS had, let us say, begin-

ning in 1986, did they start changing the interpretation of the existing rules?

Mr. ZADJURA. If I can interrupt for a second, we have some additional testimony that will address that. We just stopped to present the case studies.

Senator PRYOR. And what was your finding there? What does the additional testimony reflect?

Mr. ZADJURA. Well, what we looked at was the program administration in 1986. In 1986 toward the end of the year, there were some changes that were made that, depending on how they are interpreted, or depending on what you were doing the year before in a particular county office, could change the results, yes, sir. They made some changes, they made some clarifications and provided some guidance that really pertained to the 1987 year. So they did not impact the ones that we looked at, because we looked at activities through 1986.

Senator PRYOR. Did GAO find any county-by-county variations of interpretations?

Mr. ZADJURA. Yes, sir.

Senator PRYOR. This is pretty evident, would you say?

Mr. ZADJURA. There is county-by-county and State-by-State. My guess would be if you went in on a different day and got a different person, you might get a different interpretation.

Mr. HARMAN. And that is a problem. It is a problem we noted. We approached it from the standpoint of how many incorrect "person" determinations that resulted in; but obviously, it also results in confusion among the farmers and also results in some delays in making some decisions. So that is one thing on which we agree wholeheartedly with what the Inspector General was saying and believe that they need to make sure that their guidance is clear and consistent, whether you implement these proposed changes or not.

Senator PRYOR. Does GAO ever step out and say that proposed legislation is good or bad or would correct certain situations? I have specific reference to the legislation of reorganization before us today, Mr. Chairman.

Does GAO think that this legislation will correct some of the problems that you have brought to us in the examples?

Mr. HARMAN. Yes, we do, Senator. We believe that the proposals that the Agriculture Department is making, as related to corporations particularly, will solve this problem.

It does it because it will attribute the payments to the individual owners instead of to the corporation.

Senator PRYOR. I am trying to see also if we are going to overcorrect the situation, where we certainly want to impact these multicorporations being formed to get around the law. Is this legislation going to adversely impact the family size, individual American farmer who is not a corporate entity as you have described?

Mr. HARMAN. No, we do not believe that it will impact them. There are a couple of points I would like to make here. One is that these actions only affect about 1 percent of the producers, and only about 5 to 10 percent of the producers are at the limit. So 90 percent to 95 percent of the producers are not even at the limit. So they are not going to be impacted at all by these proposed changes.

The other point I would like to make here is that in terms of the corporations, a family farm corporation may very well be better off with these proposed changes. As it now stands, if a farmer who has, say, two of his sons or two of his adult children working on the farm with him, incorporates for tax purposes or for whatever reason, he is only entitled to one payment.

Under these proposed changes, if those other two sons are owners of the corporation also, they would also be entitled to payment; so they would be entitled to three payments instead of just one.

So for small family corporate farmers, it could very well improve their situation. But we do not see that it will impact the average farmer out there very much, if at all.

Senator PRYOR. I do not know, Senator Harkin, in Iowa how many acres it takes, let us say, of wheat or whatever, to reach the payment, the $50,000 limit. What would it be—1,000 acres, 800 acres?

In rice, I think the average would probably be around 200 acres, because of the expense of planting and in harvesting rice properly.

So are you factoring in the different types of crops in your study, Mr. Harman?

Mr. HARMAN. It is rather obvious that it might affect certain crops more than others because of the amount of acreage it takes to get to the limit.

We have seen—and correct me if I am wrong, Ed—I believe our studies showed that the reorganizations that were occurring, the larger percentage were in rice and cotton for that very reason, because it does not take as much acreage to get to the limit.

Mr. ZADJURA. In the earlier years.

Mr. HARMAN. In the earlier years.

Mr. ZADJURA. Most of the reorganizations that occurred probably in rice and cotton have already taken place if they were going to take place.

The Food Security Act of 1985 will not significantly change the payments particularly in the outyears, 1988, 1989 and 1990, so we do not expect to see much there. What will occur is there will be some more in wheat and corn, and it is still a small percentage, very small percentage, of wheat and corn farmers. But given the absolute, sheer number of wheat and corn farmers there are, it can add substantially to payments.

Senator PRYOR. Have you run any figures on what would happen if we just do away with the payment limitation, and what sort of impact it would have?

Mr. ZADJURA. In terms of increased program costs?

Senator PRYOR. Yes.

Mr. ZADJURA. Yes, we can give you a figure.

Senator PRYOR. I ought to withdraw that question, but go ahead. I would like to know.

Mr. ZADJURA. Let me caveat that this would be the change only in those payments that are subject to the limit. So it is straight deficiency and diversion payments; it is not the marketing loan payments or the payment that occurred because of the adjustment in the loan rate. So it is only the payments subject to the limit.

What we saw is that payments with the current farm bill in 1986 would be about $8.8 billion, somewhere in that neighborhood.

Senator PRYOR. That is if we did away with——

Mr. ZADJURA. No, no, no. That is about what they are with the payment limit.

Senator PRYOR. Oh, with the payment limit.

Mr. ZADJURA. If you did away with the payment limit, they would rise to about $9.4 billion. In the outyears, the spread stays pretty much the same, because we assume that some people would reorganize, and it raises the cost. In 1987, for example, it goes from about $9.1 billion to about $9.6 billion, so there is about a $500 million increase there if there was no payment limit. Now, that is in addition for the people who have reorganized and been taken into account there.

Senator PRYOR. For the time being, that is all, Mr. Chairman, and I thank the witnesses.

Senator HARKIN. Thank you, Senator Pryor. I wanted to follow up a bit on what you said and Senator Pryor was talking about.

We have the situation of the chart up there, with all these corporations being set up, and the inequity that I believe you, Mr. Harman, talked about with the family farm corporation. A lot of these were set up in the sixties, in the seventies, where you have a father and a couple of sons, and they have set up a family farm corporation—and they are all hands-on farmers; I mean, they are actually out there, working on the land. They have a family farm corporation that they were in fact instructed or advised to do so by many of our land-grant institutions, Extension Service personnel, and others, who told them, "This is the best way for you to do it," and so they set up a family farm corporation. And yet they cannot do this.

Mr. HARMAN. That is right.

Senator HARKIN. They cannot do this. So here, you might have a father and a couple or three sons in a family corporation, and they get just one payment combined limited to $50,000.

Mr. HARMAN. That is right.

Senator HARKIN. For them to do what is necessary for this, I guess they just could not do it.

Mr. ZADJURA. They would have to dissolve the corporation, go out as individuals and then start forming other entities again, which has probably tax and State tax problems.

Senator HARKIN. Big tax implications, income recognition and capital gains, and things like that. Now let me ask this. Under the legislation being proposed—I want to make this clear—the legislation that has come down to us, are you saying that under those proposed rules, if you had that family farm corporation like that where they actually were hands-on involved in farming, that they could each then get up to the limit?

Mr. HARMAN. That is correct, Mr. Chairman.

Senator HARKIN. But it would do away with this sham kind of a system.

Mr. HARMAN. That is what it would do.

Senator HARKIN. That is what I am kind of interested in, I think, is making sure that those that are actually involved get it.

I have run across this many times, I might say, Senator Pryor. Where we have had these family farm corporations, that have heard about these kinds of instances, and yet they were precluded from doing so themselves. So I am interested in taking a look at that.

One other thing I wanted to follow up on was what you mentioned about the benefits. I am trying to remember the figures you said——

Mr. ZADJURA. The percentage of farmers near the payment limit?

Senator HARKIN. Yes.

Mr. ZADJURA. Yes. Let me just back up one step. In 1985, about 3 percent of all farmers got payments of $40,000 or above, which means conversely, of course, that 97 percent got less than that.

In 1986, that will move up because there was a growth of payments from 1985 to 1986, but at most it would be 5 to 10 percent—at most—of the farmers who would receive payments of $40,000 or greater. Conversely again, 90 to 95 percent would be getting less than $40,000, and significantly, Senator, about 89 percent in 1985 and slightly less in 1986 get less than $25,000. They are not even close.

Senator HARKIN. OK. Of the 5 percent that are reorganized, what percent of total benefits go to those 5 percent?

Mr. ZADJURA. Well, the 5 percent are candidates to reorganize. In fact, we found out only about 20 percent of them reorganize. So you are really talking about 20 percent of 5 percent—1 percent of the farmers—who are doing this.

Senator HARKIN. And this 5 percent is getting what percent of the dollar benefits?

Mr. ZADJURA. Well, overall, that 5 percent of the farmers gets in excess of 20 or 25 percent.

Senator HARKIN. I get about 22 percent.

Mr. ZADJURA. Well, 3 percent of the farmers in 1985 in that category got 22. It will be a little bit higher in 1986, because it is about 5 percent of the farmers.

Senator HARKIN. Of these farmers 5 percent are getting maybe up to 25 percent of the benefits.

Mr. ZADJURA. Yes.

Senator HARKIN. And the 1 percent that have reorganized are getting—do you have any idea—half of that?

Mr. ZADJURA. No. You cannot tell, because some of those persons receiving payments in the 5 percent are corporations like this; I mean, they are a farmer like the situation we show with the 6 family members who have 15 corporations. They show up as a "person" and you really cannot tell until you go to individual cases whether or not they are real people or paper entities.

Senator HARKIN. One point I wanted to make here was that in terms of projecting the costs, you have projected out what will happen, if we do not correct this, in 1988, 1989 and 1990.

Mr. ZADJURA. That is correct.

Senator HARKIN. And the total amount of additional money—if we stop this kind of reorganization with the legislation we are looking at, what kind of savings are we looking at in the next 3 years through 1990?

Mr. ZADJURA. I have to back into that figure a little bit, because what we are saying is if there are no reorganizations after 1987 for the people who reorganized in previous years, for 1988, 1989 and 1990, they would get about $1.3 billion in payments. If you assumed reorganizations occur at about the same rate, the figure is, I believe, $2.1 billion.

Now, the bill, the proposal before Congress will not prevent every, single reorganization. You cannot lock it down that tight, because if you do, you hurt legitimate producers who happen to get close to those categories for some reason.

So you would say some portion of that—and I believe that, if my understanding is correct, CBO has estimated that the Department's bill would save about $800 million over those 3 years. We think there are a couple fixes to it that will even raise it a little higher.

Senator HARKIN. And you have proposed those fixes. Do we have this in our information?

Mr. ZADJURA. Yes. In our report and testimony, there is an explanation of what they are, yes.

Mr. HARMAN. They relate primarily to the second example which we had up there, which is not taken care of with the Department's proposals, and to another technical kind of fix that relates to how they define "persons" for corporate purposes.

Senator HARKIN. Now, I want to be clear again in my own mind that the legislation that is being proposed, you have a couple of fixes that you think ought to be put in it that would solve the second example and would boost that proposed savings from $800 million to——

Mr. ZADJURA. It really has not been scored by CBO. We know that the basic bill is $800 million-plus over 3 years. This would add some to it. It is difficult to tell, but it would add some.

Senator HARKIN. OK. But the proposed bill does nothing about this example up here?

Mr. ZADJURA. The investors, no, it does not. That is one of our changes.

Senator HARKIN. It does not do anything about this?

Mr. ZADJURA. No.

Senator HARKIN. This one, here?

Mr. ZADJURA. Oh—I am sorry, I am sorry.

Mr. HARMAN. Sorry. We were on another one.

Mr. ZADJURA. I am sorry. Yes, it does; yes, it does.

Senator HARKIN. It does take care of this?

Mr. ZADJURA. It does take care of the corporations.

Senator HARKIN. But it does not take care of the investors.

Mr. ZADJURA. That is right. It does not take care of the investor-type.

Senator HARKIN. Does it grandfather—what about someone like this one family, that specific family—will they sort of be grandfathered in?

Mr. ZADJURA. The bill as proposed does not contain any grandfathering provisions.

Senator HARKIN. So they would be cut off.

Mr. ZADJURA. They would have to comply with the new regulations, yes.

Senator HARKIN. I just want to make sure that those who had reorganized would now not be able to utilize this device.

Mr. ZADJURA. Effectively in this case with the corporations, these people would be restricted to $300,000.

Senator HARKIN. Which would be the six of them getting their $50,000.

Mr. ZADJURA. The six of them getting their $50,000, yes.

Senator HARKIN. I have no quarrel with that.

In your estimate of the savings, this $800 million——

Mr. ZADJURA. That is CBO's estimate.

Senator HARKIN [continuing]. I am sorry, CBO's estimate—do they score more of that in the first year because of the impact of these kinds of reorganizations that will have to comply then, so it will be more in the first year and less following?

Mr. ZADJURA. I have not really seen the estimate. I have been told by some of the full committee staff that is their score for the 3 years. I cannot give you the figure for the first year, no, sir.

Senator HARKIN. I thought I might, just for the record, point out some of the things that are happening to support prices out there and why we are getting into this. I will just use rice and corn since Senator Pryor and I are sitting here at the table. Rice deficiency payments in dollars per hundredweight in 1983 was $2.77 and in 1984 was $3.76; in 1985, $3.90; in 1986, $4.70; and the 1987 estimate, $4.82 in deficiency payments per hundredweight.

So those have boomed up. Corn is even more startling in terms of the percentage. In 1983 we had zero; in 1984, 43 cents; in 1985, 48 cents; in 1986, 63 cents, and in 1987, 75 cents.

So the payments per bushel are larger now, and the losses are greater, so we are getting these huge deficiency payments out there that are built into the 1985 farm bill. And then, of course, I will be asking ASCS about their administration of it.

I have a series of questions that I will not go through here, but I would like to submit them to you for response in writing if I could. Some of them we have already covered, so you can ignore those, but I do have some to submit.

Mr. HARMAN. Fine, Mr. Chairman. We will be happy to respond.

[EDITOR'S NOTE.—Questions submitted by Senator Harkin and the responses thereto follow:]

QUESTIONS

QUESTION:

Could you estimate the cost of reorganizations for the 1988-90 program years?

ANSWER:

Yes, assuming that no new reorganizations take place after 1987, then the cost of reorganizations would be about $1.3 billion for 1988-90. If reorganizations continue at the same trend we saw in our 1984-86 random sample, then the cost would be about $2.4 billion for 1988-90.

QUESTION:

Much has been written in newspapers and elsewhere about the forming of corporations as a way to circumvent the payment limit. Did you find evidence of this in your study?

ANSWER:

We found that about 16 percent of the reorganizations involved the addition of a corporation. In most cases, these corporations were owned, at least partially, by one or more persons who were near or at the limit in the prior year. As such, forming these corporations allowed people to receive additional payments and thereby circumvent the payment limit.

We also found that payments to corporations tended to be larger than for other types of reorganizations. In our sample, the average payment to a new corporation was $42,000, or about 57 percent larger than the average for other new persons. Corporations, which represented 16 percent of our sample, received 23 percent of the payments.

QUESTION:

What portion of the costs that you cited for the 1988-90 program years are due to the addition of corporations?

ANSWER:

About $300-550 million depending on whether you assume that reorganizations stop after 1987 or that they continue at the same trend as we saw in our sample.

QUESTION:

Would USDA's proposal to change the payment limitation affect the use of corporations to avoid the limit?

ANSWER:

Yes, USDA's proposal would require that payments to corporations be counted against the individual payment limit of the corporation's owners. This would prevent persons who are at the $50,000 limit from sheltering additional payments under the guise of a corporation.

QUESTION:

Would USDA's proposal prevent family farm corporations from receiving payments?

ANSWER:

No. In fact, in some cases, USDA's proposal would benefit family farm corporations because it would allow them to receive additional payments.

QUESTION:

Could you explain further how USDA's proposal would benefit family farm corparations?

ANSWER:

Yes. Under current rules a family farm corporation made up of a father and two adult children, for example, can only receive payments of up to $50,000 because the corporation is the legal person for payment limit purposes. As such, they qualify for only one payment limit. Under USDA's proposal, however, the corporation's payments would be determined by the number of its members that are actively engaged in farming. In this example, that could be up to three persons.

QUESTION:

Do you believe, based on your study and other information, that the incidence of investors joining farming operations to gain government payments is, or could become, a large problem?

ANSWER:

Yes. As shown in our case study and other cases we know of, we believe that a potential exists for large scale abuse of the payment limit in this area. The USDA has seen and reported on similiar cases.

QUESTION:

How would the options presented in your testimony deter investors from joining farming operations to receive government support payments?

ANSWER:

The option we discussed, which is similiar to that proposed by USDA for entities, would require investors to put more money up-front in terms of land or equipment in addition to financing and to actively contribute their own labor or management skills to the operation. We believe this would make it more difficult for investors to qualify without hurting the interests of legitimate farmers.

QUESTION:

Would this proposal prevent elderly or retired farmers and widows from receiving payments under a share-cropping arrangement on land they own and rent to others?

ANSWER:

No. The proposal does not apply to landowners who rent their land to others under a share crop arrangement. It relates only to investors who qualify for payments on the basis of supplying financing as their contribution--financing that is often guaranteed by the crop or the government payment. It would require that investors contribute more to the agricultural economy in terms of land, equipment, or their own labor or management skills. In effect, like the recent tax law changes, it requires active as opposed to passive interest to generate income.

QUESTION:

You stated that the number of persons at or near the $50,000 payment limit was only three percent of all producers who received payments in 1985. Can you estimate if this percentage will grow significantly in the next few years?

ANSWER:

We estimate, based on built in program growth, that this will increase to about 5 or 6 percent of all producers in 1986 and will remain fairly constant thereafter because program growth will slow dramatically after that, pushing fewer producers up against the limit.

QUESTION:

Then, in effect, what you are saying is that 90-95 percent of all producers will not be affected by the payment limit, even if we to tighten the provisions?

ANSWER:

That is correct. In fact, in 1985 almost 94 percent of all producers received payments of less than $25,000. By 1988, over 89 percent will still be receiving $25,000 or less.

QUESTION:

You discussed USDA's recent report to the Congress. How do you feel about the corrective actions they are recommending?

ANSWER:

In general, we concur with the causes USDA cited as being the driving force behind reorganizations and with their proposals to tighten the payment limitation with the two exceptions we cited in our testimony. We do, however, have two caveats to that endorsement. First, the implementing regulations and guidance will have to be carefully crafted to prevent some of the problems with interpretation that we saw in our detailed review of ASCS county office operations relating to the payment limitation. Second, ASCS needs to improve the overall administration of this program at those same county offices to alleviate the problems we discussed in our testimony.

QUESTION:

One final question. As a percent of total program costs, what portion would you estimate are due to reorganizations in 1984, as opposed to 1989?

RESPONSE:

Reorganizations represented less than one percent of annual program costs in 1984. By 1989, that figure could reach about 9 percent of annual program costs.

QUESTIONS

QUESTION:

In your work, have you analyzed any data that would indicate which types of farm business organizations would be (a) most affected and, alternatively, (b) least affected, by the proposed revisions? If so, would you describe them.

ANSWER:

Yes, most affected will be corporations set up by people already at the limit because payments to such corporations would now be counted against the individual payment limits of the corporations's owners. Also, general partnerships and other joint operations, with large numbers of members or made up of investors, because their payment limits will now be determined by the number of members who meet the revised definition of actively engaged in farming. Finally, those operations involving trusts for minor children which, in general, will be combined as one person with their parents and operations involving custom farming where there is some commonality between the owners of the custom farming operation and the actual farming operation which will also be combined as one person.

Least affected will be any operation that is not at the $50,000 payment limit which includes 90-95 percent of all farming operations and those operated by individuals, small partnerships, and family farm corporations.

QUESTION:

What portion of "persons," as they are currently defined, receiving payments for 1987 crops would be affected by the proposed revisions?

ANSWER:

Only about 5-10 percent, at most, would be affected and only then if they have reorganized in some manner to avoid the limit. As previously mentioned, 90-95 percent of all producers are not affected by the limit and would not be even if the payment limitation provisions were tightened by USDA.

QUESTION:

In your opinion, is legislation necessary to correct the problem of producers avoiding the payment limit? If so, what legislative changes do you recommend?

ANSWER:

Yes. We would recommend that the Congress enact USDA's proposed changes with the addition of the changes noted in our report and testimony relating to investors who lease land and including in the basic definition of a person those individuals who receive payments only through their ownership of corporations. Alternatively, some similar proposal that removes the restriction on the treatment of corporations and provides for determining the payment limit for entities on the basis of the number of members actively engaged in farming.

Senator HARKIN. Do you have anything else, Senator Pryor, before I dismiss this group?

Senator PRYOR. If I may, Mr. Chairman. I told you a little story on the subway train going over to vote a few moments ago. As I look further at that chart, it once again reminds me and should remind all of us of the ingenious American mind when it comes to maximizing income from a certain quantity or a fixed quantity of land or assets, and this is one of the classic examples.

I told the chairman on the train a while ago about another example of a friend of mine who is a veterinarian down in Arkansas. Years ago, he built a clinic, a very fine clinic. Behind his clinic, there sat 1 acre of land. It sat there, and it sat there, and he kept paying taxes, and it was nonproductive.

Finally, over the course of a few years when all of his friends came in, and their dogs or cats would die or have to be put to sleep, he said, "Well, I will just bury your pet out here on this acre of land.

Well, finally, this became a very well-known 1-acre pet cemetery.

Now, have you all figured out how many parakeets you can bury in an acre of land? I think he has stopped practicing veterinary medicine now.

Senator HARKIN. Yes. He has gone to the Riviera now.

Senator PRYOR. I think all he is doing is burying pets. [Laughter.]

But somehow or another, it strikes me as a very similar situation to this right here.

I really appreciate your testimony. I do not know that I agree with all of the findings that these gentlemen have today, but I want to look at this study, and I want to be very careful that once again we need to correct these situations. I do not want to overcorrect where we are doing some unnecessary damage where we do not intend to do it. That is my point, and I very much appreciate your testimony today and your report.

Senator HARKIN. Thank you very much.

Again, thank you all for your efforts and for this investigation. We will be using these findings, and we may call upon you later for some other things.

Thank you all very much.

Mr. HARMAN. Thank you, Mr. Chairman. We will be willing to work with you in any way.

Senator HARKIN. Thank you very much.

[The prepared statement of Mr. Harman and the GAO report "Farm Payments—Basic Changes Needed to Avoid Abuse of the $50,000 Payment Limit" follow:]

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Farm Reorganizations and Their Impact on USDA Payments

Statement of
John W. Harman, Associate Director
Resources, Community, and Economic
Development Division
Before the
Subcommittee on Nutrition and Investigations
Committee on Agriculture
United States Senate

GAO/T-RCED-87-40

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our work on farm reorganizations related to the $50,000 per person payment limitation. Specifically, I will be discussing the scope and cost of reorganizations and changes that are needed to improve the effectiveness of the payment limitation. This work, Mr. Chairman, was originally requested by Representatives Dorgan, Panetta, and Glickman in response to concerns that farmers were increasingly reorganizing their farming operations to avoid the payment limitation restrictions by adding new persons.

Our work on this issue was done in two segments. In April of this year we reported on the first segment which focused on (1) identifying the number of new producers (i.e., persons) created as a result of farm reorganizations from 1984 to 1986; (2) estimating the additional cost to the government of these reorganizations; and (3) projecting the additional costs of such reorganizations, if the trend in reorganizations were to continue in fiscal years 1987 to 1989.[1] Just this week, we reported on the second segment of our work which looked at the methods used to avoid the payment limit, USDA's proposed changes to the law and regulations which

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[1]Farm Payments: Farm Reorganizations and Their Impact on USDA Program Costs (GAO/RCED-87-120BR, April 1, 1987).

are designed to tighten the limitation, and USDA's process for determining whether reorganizations were proper for payment limitation purposes.[2]

My testimony today will use our earlier work on the number and cost of reorganizations as a backdrop for presenting our analysis of USDA's proposals to tighten the payment limitation including some additional changes that USDA could make to enhance the effectiveness of its proposals.

BACKGROUND ON PAYMENT LIMITATIONS

The Congress initially passed a limitation on direct income support payments in response to both the high cost of federal farm programs and reports of large subsidy payments to individual producers. The current limit is $50,000 per person in direct subsidy payments for producers of wheat, feed grains, cotton, and rice. Under the payment limitation regulations, persons are broadly defined to be individuals, members of joint operations, or entities such as limited partnerships, corporations, associations, trusts, or estates that are actively engaged in farming.

In addition to the $50,000 limit on direct support payments, separate limits have been placed on other programs, such as the new

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[2]Farm Payments: Basic Changes Needed to Avoid Abuse of the $50,000 Payment Limit (GAO/RCED-87-176, July 21, 1987.)

$200,000 per-person limit on marketing loans and other payments beginning with crop year 1987. Although separate, these other limits use the same definition of a person for payment limitation purposes.

NUMBER AND COST OF REORGANIZATIONS

During our review we identified an increasing trend in reorganizations from 1984 through 1986 that may have been related to the $50,000 payment limitation. Between 1984 and 1986, these reorganizations added almost 9,000 new persons to USDA payment rolls at an additional cost of $328 million. We estimate that should the trend in farm reorganizations continue, reorganizations since 1984 could be adding almost $900 million annually to program costs by 1989. Cumulative costs for the 6-year period, 1984 to 1989, could approach $2.3 billion.

1984 Through 1986 Reorganizations

During 1984, 1985, and 1986, about 31,000, 50,000, and 66,000 new persons, respectively, were added to USDA's program payment rolls for a variety of reasons. These included inheritance of farmland, establishment of totally new farming operations, and farm reorganizations. Some of these new persons were part of operations that received payments in prior years.

The number of persons receiving direct payments of $40,000 or greater increased dramatically from about 4,300 in 1983 to about 29,000 in 1985. While the 1985 figure still represents only about 3 percent of all persons receiving direct payments, it nonetheless shows that a large number of farmers may now have an incentive to reorganize their operations as they near or meet the payment limit.[3]

On the basis of a statistically valid random sample of new persons, we project, as shown on chart 1, that about 1,400, 1,900, and 5,700 new persons were created as a result of farm reorganizations in 1984, 1985, and 1986, respectively. In each instance, at least one producer on the original farming operation received $40,000 or more in payments. The 3-year cumulative total is about 9,000 new persons.

We found that as more persons neared or met the payment limitation from 1983 to 1985, the number of new persons created in the following years increased. Although it was not our objective to prove that the intent of these reorganizations was to avoid the payment limit, that was the effect. Further, anecdotal evidence we obtained from state and local agricultural officials, farmers

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[3]For the years 1984 to 1986, we used $40,000 in our analysis as the point at which farmers might begin to reorganize their operations in anticipation that they might reach the $50,000 per-person limit in future years because of increasing government per-unit support payments and higher crop yields.

who reorganized, and other sources tends to support such avoidance as a driving force behind at least some of the reorganizations.

The increase in farmers nearing the payment limit is primarily due to an increase in the per-unit deficiency payment rate and generally higher crop yields over the past few years. The impact of these factors is illustrated by the declining number of acres that must be planted to reach the $50,000 payment limit. For example, as shown on chart 2, the acreage needed to reach the $50,000 payment limit on a corn farm has decreased by about 800 acres, or 51 percent, from 1983 to 1987 on the basis of a nationwide average yield and compliance with the mandatory minimum program requirements. For wheat, the corresponding decline is about 1,000 acres, or 44 percent. The acreage needed to reach the payment limit for cotton and rice has also declined--although not as sharply--by 20 and 13 percent, respectively.

1987 Through 1989 Reorganizations

Should the trend in reorganizations[4] continue over 1987 to 1989, we project that an additional 22,000 new persons could be

[4]We used the 3-year weighted average number of reorganizations from 1984 to 1986 to estimate the number of producers who might reorganize in subsequent years. Because the year-to-year growth in support payments has slowed considerably, we assumed that only those persons who actually reach the $50,000 limit would have the incentive to reorganize in the 1987 to 1989 time frame. This analysis assumes that producers receive the full deficiency payment permitted under the Food Security Act of 1985 and USDA budget proposals for 1987 to 1989.

receiving payments by 1989. While the continuation of this trend is not certain, we believe that it is likely because (1) there can be a significant economic benefit of up to $50,000 for each person added to a farming operation, (2) in the future, additional persons on existing operations may continue to reach the payment limit because of continued high program payments and increased crop yields, and (3) a large reservoir of persons, about 38,000 in 1986, at the payment limit could realize this economic benefit by reorganizing their farming operations in the future. If this trend continues, additional costs to the government, as shown in chart 3, could be about $191 million in 1987, $209 million in 1988, and $219 million in 1989. These figures represent the annual cost of only those new persons added to farming operations in that year. In 1989, the total of almost 31,000 new persons that resulted from farm reorganizations since 1984 could add almost $900 million annually to program costs.

While the annual costs resulting from farm reorganizations have increased significantly over the years, the cumulative cost of these reorganizations are accelerating dramatically. As shown on chart 4, the cumulative cost for 1984 to 1989 would be about $2.3 billion with $900 million added in 1989 alone. Another $900 million would be added in 1990, the last year covered by the 1985 Food Security Act.

Even if we were to assume that no new reorganizations would take place after 1987, the cumulative costs of reorganizations that took place from 1984-87 would be about $1.7 billion through 1989 and about $2.1 billion through 1990. The costs for only the 1988-90 program years would be between $1.3 billion if you assume that new reorganizations would stop entirely after 1987 and $2.4 billion if you assume that they continue after 1987.

METHODS USED TO AVOID THE PAYMENT LIMITATION

During our review, we saw a wide variety of reorganizations including the addition of individuals, limited partnerships, corporations, and trusts, to the establishment of large partnerships or joint ventures. The two areas of primary concern are the formation of corporations and the renting of farmland for cash by individuals, partnerships, or joint ventures with a large number of participants. A corporation can be formed by two persons who each receive the maximum $50,000 payment to receive a third $50,000 payment as long as neither person owns more than 50 percent of the corporation.

In the cash-rent situation, individuals, general partnerships, or joint ventures (all members of which qualify as individuals each with a $50,000 payment limitation) rent farmland for cash. A large number of individuals can be added to the point where all possible payments on a given operation are maximized. We saw instances

where farm owners broke up their operation by renting their land to investors who leased equipment, hired labor, and hired managers to operate the farm. The individual investors who supplied only financing for the operation are each entitled to a $50,000 payment. In some cases this financing was obtained by using either the crop or the government payment as collateral. Under this arrangement, the individual members or investors may live hundreds to thousands of miles away from the farming operation for which they are receiving federal payments, including as far as Australia, France, and Pakistan.

At this time Mr. Chairman, I would like to pause for a few moments and have Mr. Ed Zadjura of my staff present two case studies that demonstrate how these types of reorganizations have been used to avoid the payment limitation and obtain multiple payments.

[Presentation of Case Studies]

Mr. Chairman, the case studies just presented are illustrative of some of the most extreme, although legal, cases of avoidance of the payment limitation. In general, most reorganizations involve the creation of only one or a few new persons.

OBSERVATIONS ON USDA'S PROPOSED CHANGES

In March of this year, USDA presented to the Congress a report containing its proposals to tighten the payment limitation. USDA's proposals include changes to both the law and regulations. We believe that USDA's proposals, if properly implemented, will discourage many farm reorganizations specifically designed to avoid the payment limit like the examples just discussed.

USDA's proposals remove the incentive to incorporate or add investors not actually engaged in farming as members of a joint operation to avoid the limit. The proposals accomplish this by

-- treating all entities the same by basing the payment limit for each on the number of its members actively engaged in the entity's farming operation;

-- attributing payments for the entity against the individual payment limits of its owners; and

-- limiting total payments for individuals to $50,000, whether the payments originate from their own farming operations or are attributed to them from an entity, such as a corporation, in which they share ownership.

USDA's proposals also include changes that will make other payment limitation rules more restrictive. For example,

-- minor children will always be combined with their parents, except when the child maintains a separate household and carries out the actual farming operations on a farm in which the parents have no interest;

-- custom farmers--those that perform services for other farmers for a fee--will always be combined with the operations they farm except when they have no interest in the farm or crops;

-- the increase in persons with separate payment limitations will be limited in proportion to any increase in land, when land is the substantive change in a farm reorganization that justifies the increase in persons; and

-- all entities will be combined when two or more persons own 50 percent or more of each of the entities.

USDA's proposals do not, however, address avoidance of the payment limit through division of land into parcels that earn the payment limit and the leasing of these parcels to investors not otherwise involved in farming. The investors' involvement in farming is limited to providing financing and signing land lease,

equipment rental, management, and labor agreements provided by a management firm that put the investment package together. USDA could eliminate this method of legal avoidance by changing its rules to require that in rental situations, in addition to financing, a person other than a landowner, must contribute (1) owned land or equipment, and (2) personal labor or active management to receive program payments.

Also, while USDA intended that payments to any individual be limited to $50,000 whether the source of the payments was the individual's own farming operation or one in which they shared ownership, their proposal will not achieve this intended goal in all cases. This can occur because the basic definition of a person requires that a person have a separate interest in the crop. However, owners of corporations are not considered to have a separate interest in the crop, rather the corporation has the only interest in the crop.

As such, owners of corporations under current and proposed rules will not be considered persons for payment limits unless they have some other farming interest outside the corporation that qualifies them as persons. As a result, such individuals could receive payments in excess of $50,000 because they are not considered persons for payment limitation purposes and therefore there is no limit on their payments. ASCS can correct this problem by including these individuals in its definition of a person.

Some of the changes suggested by USDA will need congressional action to be implemented; others can be implemented administratively. Specifically, for USDA to implement the major thrust of its proposal, the Congress will have to (1) eliminate existing legislative requirements about how corporations are considered for payment limitation purposes and (2) authorize the determination of payment limits for legal entities on the basis of the number of its members actively engaged in its operation. However, USDA can change the rules about minor children, custom farming, and substantive change under existing legislative authority.

USDA's proposals include necessary legislative language for implementation but do not include regulatory language. USDA will have to develop clear and precise regulations and guidance to assure effective implementation. For example, USDA county offices will have to determine how many members of an entity are actively engaged in the entity's farming operation, as determined by how many members make significant independent contributions of capital, land, or equipment and labor or management to the entity's operation. USDA will need to define what a significant contribution is and how to value contributions other than capital for this determination.

PROGRAM ADMINISTRATION PROBLEMS

We also identified some problems in USDA's administration of the payment limitation at the county and state office levels. These problems contribute to the creation of new persons through reorganizations that are of questionable validity. In separate reviews, GAO and USDA's Inspector General found that over 20 percent of the reorganization cases reviewed may have been incorrectly approved.

For example, county offices have inconsistently applied the regulation that a reorganization must involve a "substantive" change in the farming operation in order for any new persons to qualify for payments. In part, this inconsistency resulted because USDA has not provided clear guidance or criteria on what constitutes a substantive change. The regulations instead provide only examples of what constitutes a substantive change. These examples include a change in the amount of land being farmed and dissolution of an entity such as a corporation. As a result, USDA headquarters and county offices use different criteria. For example, USDA headquarters officials, when reviewing and approving reorganization cases, apply the criterion that the land being farmed increase or decrease by about 20 percent before they will approve a reorganization that adds new persons. In one county office we visited, simply adding a person is considered a

substantive change. In another county office, a 20-percent increase in land is a mandatory requirement for approval.

In another instance, USDA officials in the California state office incorrectly interpreted the regulations relating to financing of general partnership operations. The regulations require that each partner obtains any necessary financing without guarantees from other partners or the partnership as a whole in order to qualify for an individual $50,000 payment limitation. We found, however, that individual partners were using partnership assets to obtain their financing. As a result, three of eight general partnership cases we looked at in one county were incorrectly determined, resulting in overpayments to nine persons totaling $206,000 in 1986. The county program director estimated that as many as 50 percent of all general partnerships in the county may have been incorrectly approved.

As a final example, in many instances county offices are not requiring consistent documentation to support reorganization plans submitted for approval. While some offices require evidence of incorporation, financing, lease arrangements, and capital investment, other county offices require little or no documentation to support that a substantive reorganization had taken place, which justified the approval of new persons for payments. In one county office, none of the 12 cases we reviewed had sufficient documentation to support the approval of new persons. As a result,

11 new persons were paid $392,000 in 1986. In an audit of 1984 payments, the Department's Inspector General uncovered similar problems. During follow-up work on individual cases, the Inspector General found that in one-third of the cases they questioned there was insufficient documentation to justify approval of the reorganization plans.

Incorrect person determinations occurred primarily because USDA did not provide adequate guidance and training on how the regulations should be implemented and did not exercise effective internal control to ensure that person determinations were made in accordance with regulations. In all fairness, Mr. Chairman, we need to recognize that USDA has taken some corrective actions that will improve administration of the payment limitation beginning with the 1987 program year.

In December 1986 ASCS revised its guidance for state and county offices use in reviewing person determinations for the 1987 program year. These revisions address some but not all of the problems we noted. For example, the revised guidance reemphasizes the need to verify that actual farming operations were carried out according to the farm operating plan that was the basis for approving new persons. ASCS has also increased the amount of training provided to state officials from a half-day of training in 1985 and 1986 to a full day of training during a recent meeting.

However, the revised guidance still does not address such important considerations as how to determine if payment shares are commensurate with actual contributions in joint operations or the type of information and documentation needed to apply specific rules or verify that operations are carried out as planned. Further, ASCS still has not developed minimum training requirements for county officials who actually make person determinations or developed uniform course materials to assure that the rules are consistently applied by different counties and states.

Providing adequate guidance, training and internal control of person determinations will be even more important if changes are made to the existing law and regulations.

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In closing, Mr. Chairman, I would like to emphasize two points that help put this issue in context. First, while reorganizations are significantly increasing program costs, they represent the actions of less than one percent of all producers. Second, most producers, 90-95 percent, receive payments of less than $50,000 and are not subject to the payment limit. As a result, most persons will not be affected by the proposed changes and will continue to receive at least their current level of payments.

Mr. Chairman, that concludes my prepared statement. My colleagues and I will be happy to answer any questions you may have.

Chart 1: Producers Paid $40,000 or More and New Persons Created by Reorganizations Among Those Producers

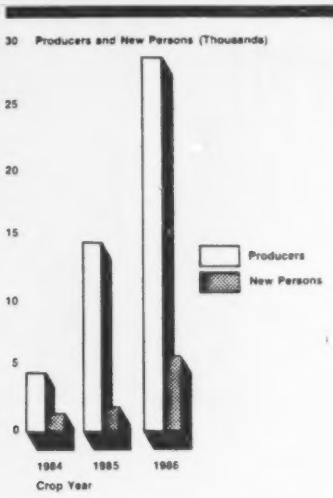

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Chart 2: Acreage Needed To Reach $50,000 Limit

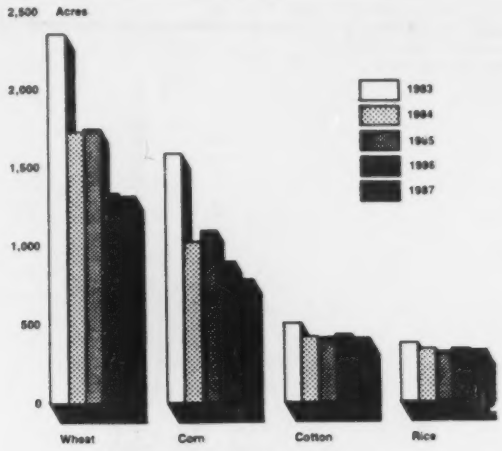


Chart 3: Annual Payments to New Producers Resulting From Farm Reorganizations

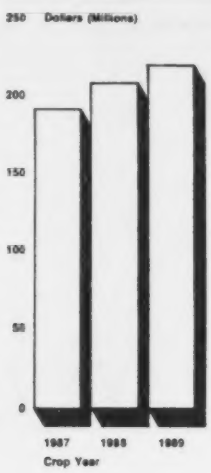
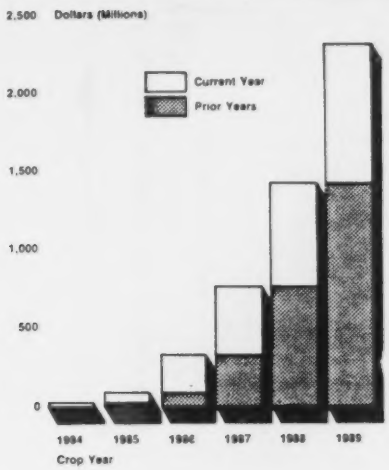


Chart 4: Cumulative Payments to New Producers Resulting From Farm Reorganizations



Case Study #1

Reorganization Using Multiple Corporations

This case demonstrates how a farming operation reorganized to take advantage of a loophole in the legislation that allows the creation of legal or "paper" entities, such as a corporation, limited partnership, or trust to constitute a person in its own right. Such entities qualify for an individual $50,000 payment as long as no stockholder owns or controls more than 50 percent of the stock. As a result, two persons who each are already receiving the maximum $50,000 payment can reorganize their farming operation and form a corporation that also receives $50,000. The co-owner's share of this payment is not charged against their individual limit. As this case study shows, this loophole can lead to the formation of numerous corporations by a small group of people with the potential for multiple payments.

In 1985, a six member joint venture operated 5,841 acres of farm land which the participants in the venture either owned or cash leased from others. The joint venture comprised a father, his four adult sons, and an adult daughter. USDA officials determined that each individual member in the venture qualified as a person for payment limitation purposes under USDA regulations and could receive up to $50,000 in direct support payments subject to the limit.

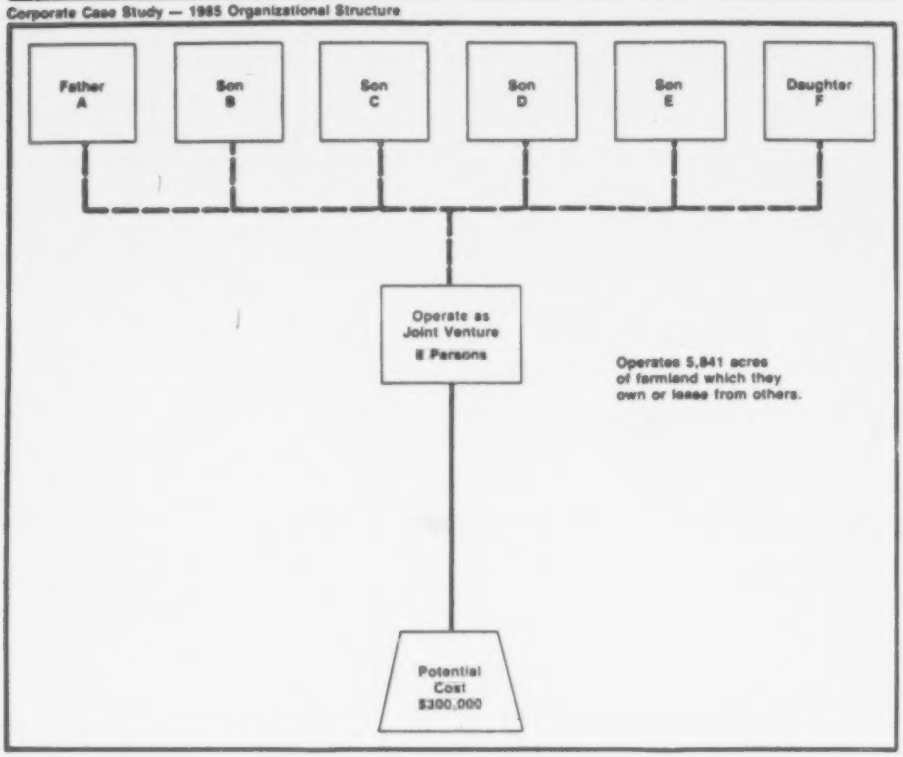
The joint venture's 1985 farm operation qualified for about $595,000 in payments subject to the limit. The father, since he was operator of much of the land, exceeded the $50,000 limit on his payment and, as a result, he did not receive about $315,000 that was earned and attributable to his interest in the operation. Each of his five children received about $46,000 as the result of their interests in the 1985 operation.

For 1986, the operation was reorganized by the father and his children into a new joint venture that comprises the same six persons as in 1985 plus 15 new corporations they formed. Each corporation is owned on a 50/50 basis by two individuals, each of whom was a member of the 1985 joint venture. The new joint venture operated 6,870 acres of farm land which were either owned or cash leased by its members.

USDA officials determined that each of the six individuals and 15 corporations comprising the 1986 joint venture qualified as a person and could receive up to $50,000 in direct support payments subject to the limit. Their 1986 farm operation earned about $1,230,000 in direct support payments. This resulted in $50,000 to each of the 21 persons comprising the joint venture for payment limitation purposes for a total payment of $1,050,000. The remaining $180,000 is the amount earned payments exceeded the joint venture's cumulative payment limitation under its 1986 organization.

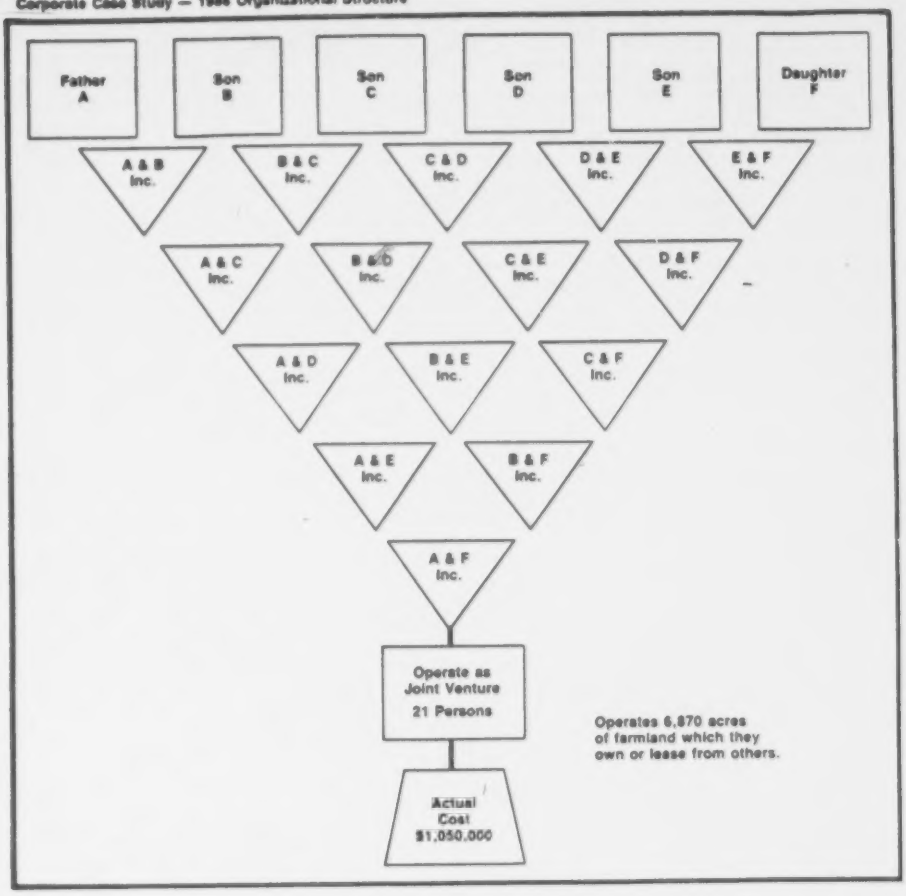
APPENDIX II

Corporate Case Study — 1985 Organizational Structure



APPENDIX II

Corporate Case Study — 1986 Organizational Structure



APPENDIX II

Case Study #2

Reorganization Showing Investors
That Cash Rent Farms

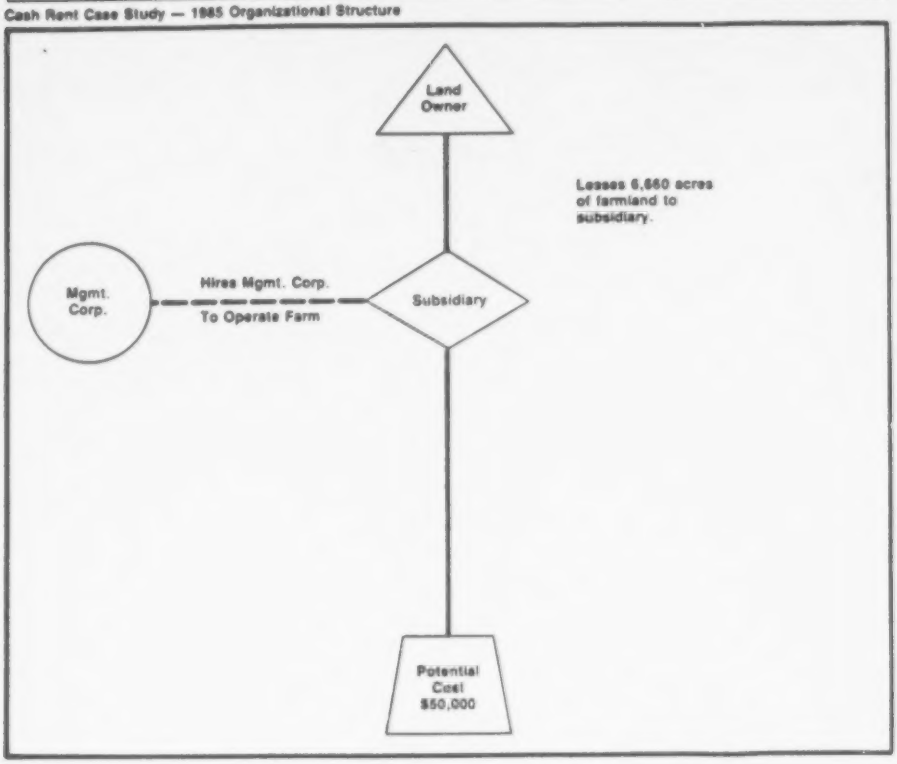
This case study shows how investors with little or no active farming interests of their own can take advantage of USDA's definition of what constitutes a person actively engaged in farming. Under the regulations, a person is someone who has a separate and distinct interest in the land or crop, exercises separate responsibility for that interest, and is responsible for farming costs from a fund or account separate from other persons. As such, an investor who owns no farmland, equipment, or farm buildings, and does not actually work on the land, but has the personal resources to finance or obtain bank financing for operating costs can qualify for payments. In some cases, persons have pledged future government payments as security to obtain operating loans, loans which enable them to finance their operation and obtain the same government payments pledged as collateral for the loan. As this case study shows this can also lead to multiple payments.

In 1985, a subsidiary that cash leases 6,660 acres of farmland from its parent company, hired a management company to run its farm operation. Under this organizational structure, only the subsidiary, as operator of the farm, could qualify as a person for payment limitation purposes and receive up to $50,000 in direct support payments subject to the limit. No payments were made, however, because the subsidiary chose not to participate in the 1985 programs.

For 1986, the same farmland was subleased by the subsidiary to the management company it hired for 1985. The management company in turn subdivided the 6,660 acres into parcels of about 238 acres and subleased them to 28 separate investors under individual cash rental agreements drawn by the management company. The investors supply operating capital, lease equipment, sub-contract for labor, and hire a farm manager.

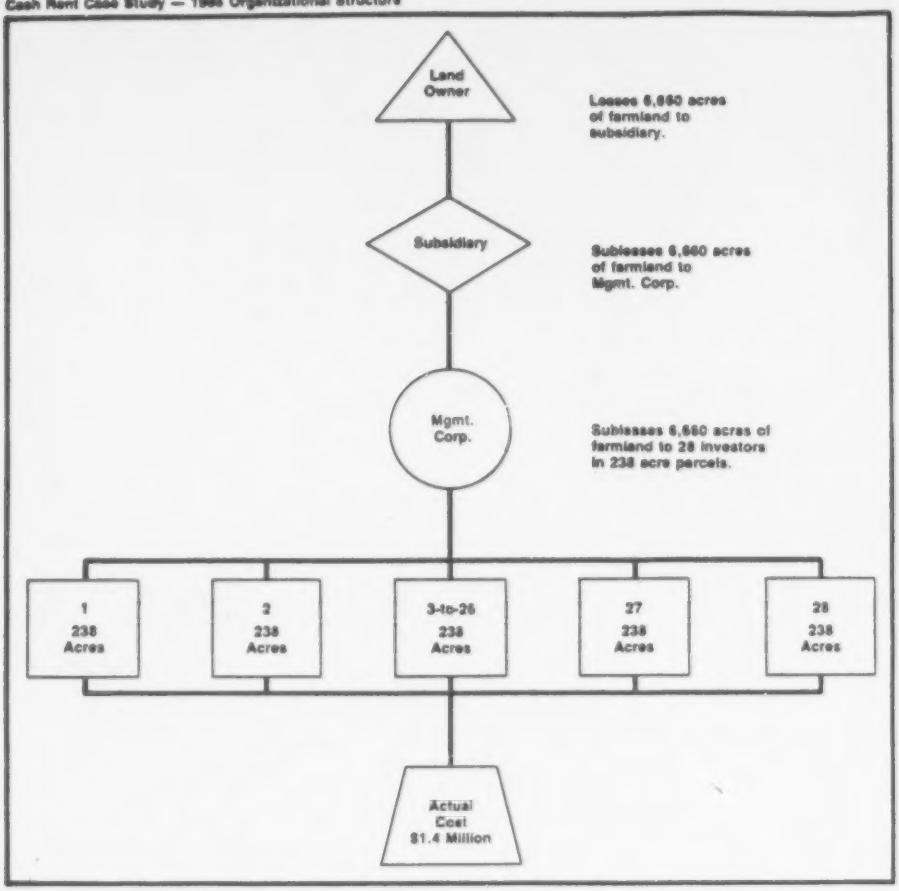
Under USDA regulations, the 28 investors, as operators of the farms, each qualify as a person for payment limitation purposes. As such, each can receive up to $50,000 in direct support payments subject to the limitation. Each of the investors hit the limit for 1986 for a total cumulative payment of $1.4 million.

Cash Rent Case Study — 1985 Organizational Structure



APPENDIX II

Cash Rent Case Study — 1986 Organizational Structure



United States General Accounting Office

GAO

Report to Congressional Requesters

July 1987

FARM PAYMENTS

Basic Changes Needed to Avoid Abuse of the $50,000 Payment Limit

GAO/RCED-87-176

GAO United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-225866

July 20, 1987

The Honorable Byron L. Dorgan
The Honorable Dan Glickman
The Honorable Leon E. Panetta
House of Representatives

In response to your June 18, 1986, request and subsequent discussions with your offices, this report discusses the Department of Agriculture's administration of the $50,000 limit on direct agricultural support payments, farm reorganizations to avoid the limit, and changes necessary to reduce avoidance of the limit. It also briefly summarizes detailed information about the impact of farm reorganizations made to avoid the limit. We reported that information to you in our April 1987 report, Farm Payments: Farm Reorganizations and Their Impact on USDA Program Costs, GAO/RCED-87-120BR. As you also requested, we have included information on the laws and regulations relating to the payment limitation as well as an explanation of the application of these regulations in appendixes I through IV of this report.

As arranged with your office, we are sending copies of this report to the Secretary of Agriculture and the Director, Office of Management and Budget. Copies will also be made available to other interested parties upon request.

This work was conducted under the direction of Brian P. Crowley, Senior Associate Director. Other major contributors are listed in appendix VII.

J. Dexter Peach

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

U.S. Department of Agriculture (USDA) crop support payments increased from $4.2 billion in 1984 to about $8.8 billion in 1986.

Representatives Byron L. Dorgan, Dan Glickman, and Leon E. Panetta were concerned that some producers were trying to avoid the $50,000 limit on payments to individual producers by reorganizing their farming operations to qualify for additional payments and asked GAO to

- determine the scope of the problem and estimate the cost of reorganizations for 1984-89,
- identify the methods used to avoid the payment limit and ways to tighten current payment limitation provisions, and
- review the effectiveness of USDA's administration of the payment limit.

Background

USDA makes direct income support payments to farmers under annual commodity and acreage reduction programs for wheat, feed grains, cotton, and rice. These payments are made in the form of deficiency and diversion payments. Deficiency payments are based on the difference between the government-established target price for a commodity and the higher of the commodity's average market price or its prescribed loan rate. Diversion payments compensate farmers who agree to take a percentage of their acreage out of production for the commodities that they would have grown on the idled acres.

Congress limited direct income support payments to reduce costs and prevent farmers from benefiting excessively. The current $50,000 per person limit was established in 1981 and extends through 1990. Under existing laws and regulations, persons are broadly defined to be individuals, members of joint operations, or entities such as limited partnerships, corporations, associations, trusts, and estates that are actively engaged in farming. As such, a reorganization which adds a new person or persons to a farming operation can result in greater payments because each new person can qualify for up to $50,000 in payments. USDA must review and approve all reorganizations that add new persons for payment limitation purposes.

Results in Brief

Under existing law and regulations, it is relatively easy to reorganize a farming operation so that additional persons can receive payments. GAO estimates that if the current trend in reorganizations continues, 31,300 additional persons could be receiving payments by 1989 and total costs could increase by an additional $2.3 billion from 1984-86.

In March 1987 USDA proposed changes in the law to tighten the payment limit by treating all entities the same and counting payments against the individual owners' limits, thereby eliminating the advantage of adding new persons to farming operations. While USDA's proposal will eliminate most of the existing ways to avoid the payment limit, it does not eliminate all of them. USDA can administratively change other regulations that will further tighten the payment limitation provisions. In addition, GAO found that USDA has not effectively administered existing law and regulations governing the payment limitation. As a result, many of the reorganizations that were approved by USDA did not comply with existing regulations and procedures.

Principal Findings

Scope and Cost of Reorganizations

In 1984-86 reorganizations among producers who were at or near the payment limit added about 9,000 new producers to USDA payment rolls. While it was not GAO's purpose to prove that the intent of these reorganizations was to avoid the payment limitation, that was the effect. If this trend in reorganizations among producers affected by the payment limit continues through 1989, total program costs could increase by $2.3 billion. (See chapter 2).

Changes to Current Law and Regulations Needed

Individuals and other legal entities can avoid the $50,000 payment limitation in a variety of ways. Three methods that result in the largest number of new persons for payment limitation purposes involve (1) individuals who form new legal entities, such as corporations, that qualify as new persons to operate parts of their farming operations (2) joint operations that add individuals or other legal entities who qualify as new persons but who otherwise are not engaged in farming; and (3) individuals or entities who previously farmed their own land but now lease their land to investors who can qualify for separate payments. (See chapter 3).

While USDA has proposed changes that will eliminate most existing ways to avoid the payment limitation, they are not as effective as they could be. For example, the changes will not prevent the division and lease of land to investors not otherwise engaged in farming who can qualify as additional persons. GAO has identified ways for USDA to eliminate this and other methods of avoidance also. (See chapter 4).

USDA Program Administration Needs Improvement

GAO and the USDA Inspector General, in two separate reviews, found that USDA improperly approved new persons for program payments in over 20 percent of the cases reviewed. The improper determinations occurred because USDA had not provided adequate guidance and training to or internal control over the officials reviewing the cases.

GAO reviewed 64 new person determination cases in 7 counties based on current law and regulations to determine if USDA was effectively administering the program. Based on the available documentation, GAO's review showed that in 29 cases there were potential overpayments of $2.4 million in 1986.

The USDA Inspector General's detailed review of 225 cases revealed actual overpayments of $15.7 million from 1981-86. (See chapter 5).

Recommendations to Congress

USDA has proposed changes to the law and regulations to reduce avoidance of the payment limit by treating all legal entities alike and by counting payments to legal entities against the payment limits of the individuals who own those entities. USDA officials are awaiting congressional action on its legislative proposal before making any regulatory changes.

GAO recommends that the Congress adopt USDA's proposed legislative changes or some alternative proposal that would have a similar effect.

If Congress decides not to adopt USDA's entire legislative proposal, GAO recommends that, at a minimum, Congress remove the existing legislation provision that requires a corporation to be treated as a separate person for payment limitation purposes. If left in place, this provision will prevent USDA from making other regulatory changes necessary to reduce avoidance of the payment limit.

Recommendations to Secretary of Agriculture

GAO is recommending several actions that USDA can take to reduce avoidance of the payment limitation depending on what action the Congress takes on USDA's proposed legislation.

USDA should also improve its guidance and training of officials who are responsible for approving farm reorganizations and improve its internal control of their activities to assure that person determination cases are made in accordance with established regulations.

Specific recommendations are discussed in chapter 6.

Agency Comments

GAO discussed this report with ASCS officials who generally agreed with its contents. However, as agreed with your offices, GAO did not obtain official agency comments on a draft of this report.

Contents

Executive Summary		2
Chapter 1 Introduction		10
	Limits on Direct Income Support Payments	10
	Objectives, Scope, and Methodology	11
Chapter 2 Farm Reorganizations Are a Growing Problem That Increases Program Costs		16
	Factors Influencing the Increased Number of Producers Nearing the Payment Limit	16
	Farm Reorganizations Increased Rapidly During 1984-86	16
	Farm Reorganizations Could Increase During 1987-89	18
	Total New Persons Resulting From Reorganizations Related to the Payment Limitation in 1984-89 and Their Annual and Cumulative Program Payments	19
Chapter 3 Current Law and Regulations Make It Relatively Easy to Avoid the Payment Limit		21
	Use of Corporation and Joint Operation Rules to Avoid the Payment Limit	21
	Other Rules That Contribute to the Avoidance of the Payment Limit	22
Chapter 4 USDA Has Proposed Changes to Reduce Avoidance of the Payment Limit, but Additional Changes Are Needed		28
	Principal Thrust of USDA's Proposals	28
	USDA's Proposals Will Also Make Other Rules That Contribute to Avoidance More Restrictive	29
	Changes in Law Necessary to Implement USDA's Proposals	30
	USDA's Proposals Still Have Some Loopholes	31
	Other Options to Reduce Avoidance of the Payment Limitation Are Less Effective Than Those Proposed by USDA	32
	Clear Regulations and Guidance Required to Implement USDA's Proposals	34

Chapter 5 ASCS Needs to Improve Its Administration of the Payment Limitation
35
Results of Reviews of County Office Operations 35
Need for Improved Guidance 36
Need for Improved Internal Controls 41
Need for Improved Training 42
Corrective Actions by ASCS 43

Chapter 6 Conclusions and Recommendations
45
Recommendations to Congress 46
Recommendations to the Secretary of Agriculture 46

Appendixes
Appendix I: Payment Limit History 50
Appendix II: Section 1001 of the Food Security Act of 1985, as Amended 52
Appendix III: 7 CFR 795 - Payment Limitation 56
Appendix IV: USDA's Explanation of How the Payment Limitation Is Applied 61
Appendix V: ASCS State and County Offices Included in GAO Review 74
Appendix VI: USDA's Proposed Amendment to Section 1001 of the Food Security Act of 1985 75
Appendix VII: Major Contributors to This Report 79

Figures
Figure 2.1: Acreage Needed to Reach the $50,000 Limit 17
Figure 2.2: Number of New Persons Resulting From Reorganizations Related to the Payment Limitation, 1984-89 19
Figure 2.3: Total Annual and Cumulative Payments to New Persons Resulting From Reorganizations Related to the Payment Limitation, 1984-89 20
Figure 3.1: Corporate Case Study-1985 Organizational Structure 23
Figure 3.2: Corporate Case Study-1986 Organizational Structure 24
Figure 3.3: Division and Lease of Land Case Study 26

Abbreviations

ASCS	Agricultural Stabilization and Conservation Service
GAO	General Accounting Office
RCED	Resources, Community, and Economic Development Division
USDA	United States Department of Agriculture

Chapter 1

Introduction

The U.S. Department of Agriculture (USDA) is authorized by the Agricultural Act of 1949, as amended, to make direct income support payments to farmers under annual commodity and acreage reduction programs for wheat, feed grains, cotton, and rice. Since 1973, these payments have been made in the form of deficiency payments. Deficiency payments are based on the difference between the government-established target price for a commodity and the higher of the commodity's average market price or its loan rate[1]. In 1986, for example, participating corn producers received $0.63 per bushel in deficiency payments based on the difference between the government-established target price of $3.03 and the original loan rate of $2.40, which was higher than the market price, for each bushel produced.

In addition, beginning in 1978, land diversion payments were added under acreage set-aside provisions covering specific program crops. Diversion payments compensate farmers who agree to take a percentage of their acreage out of production for the commodities that they would have grown on the idled acres. In 1986, a diversion payment of $0.73 per bushel was also paid to participating corn producers to compensate them for acreage voluntarily idled. Total combined deficiency and diversion payments are limited under current law to a maximum of $50,000 per person per year.

The Agricultural Stabilization and Conservation Service (ASCS) within USDA administers the annual commodity and acreage reduction programs and the $50,000 payment limit. For the 1984 and 1985 programs, total deficiency and diversion payments (those subject to the limit) for wheat, feed grains, cotton, and rice were $4.2 billion and $5.9 billion, respectively. USDA estimates 1986 program costs at $8.8 billion.

Limits on Direct Income Support Payments

The Congress initially passed a limitation on direct income support payments in response to both the high cost of federal farm programs and reports of large subsidy payments to individual producers. The current limit of $50,000 per person in direct subsidy payments for producers of wheat, feed grains, cotton, and rice was established in 1980 and extended through 1990 by the Food Security Act of 1985 (Public Law 98-198). Under the payment limitation regulations, persons are broadly defined to be individuals, members of joint operations, or entities such

[1]Price support loans are designed to assure farmers of a minimum price for their crop. If the market price is below the loan rate for a crop the farmer can keep the loan amount and turn over the crop to the government as payment in full.

as limited partnerships, corporations, associations, trusts, and estates that are actively engaged in farming.

Besides the $50,000 limit on direct support payments, separate limits have been placed on other agricultural programs. As part of the 1987 continuing appropriations act, Public Law 99-591, a new $250,000 per-person, per-year, limit was placed on these payments. This limit includes the existing $50,000 per-person limit on deficiency and diversion payments. The remaining portion of the limit applies to disaster payments, which had previously been limited to $100,000 per person, and various other payments not previously limited. In addition, there is a separate annual limit of $50,000 per person for the long-term conservation reserve program that was established by the Food Security Act of 1985. While separate, these limits use the same legislative and regulatory provisions to determine who or what constitutes a person for payment limitation purposes.

Under the 1985 Food Security Act, covering crop years 1986-90, it is possible that direct support payments could reach unprecedented high levels. This, in turn, could lead to more producers reaching the $50,000 per-person limit in 1986 and beyond and to higher overall program costs if those producers reorganized their farming operations to create new producers to avoid the limit. For example, a producer who raises enough crops to earn $100,000 in payments can receive only $50,000 because of the payment limit. However, if that producer could reorganize the operating structure of that farm by taking in a partner, then they each could receive up to $50,000 in payments or a total of $100,000.

A history of the payment limitation provisions is included as appendix I, and the current payment limitation provisions of the Food Security Act of 1985, as amended, are included as appendix II. The regulations (7 CFR 795) implementing the payment limit are included as appendix III, and an explanation of the current application of these regulations provided by USDA is included as appendix IV.

Objectives, Scope, and Methodology

We made this review at the request of Representatives Byron L. Dorgan, Dan Glickman, and Leon E. Panetta, who were concerned that farm reorganizations to avoid the $50,000 payment limit were a factor contributing to the increased costs of the commodity programs.

In accordance with agreements reached with the requesters, our objectives in this review were to

- determine the scope and budgetary impact of farm reorganizations by identifying the number of new persons paid in 1984-86 as a result of reorganizations to avoid the $50,000 payment limit and the impact on fiscal years 1987-89 costs if the trend in reorganizations continues (chapter 2),
- provide a summary and explanation of the laws and regulations that contribute to the avoidance of the payment limit (chapter 3),
- identify any changes in the law and regulations needed to reduce the avoidance of the payment limit (chapter 4), and
- determine whether USDA's administration of the payment limitation is in compliance with existing laws and regulations (chapter 5).

Number of New Persons Paid in 1984-86 as a Result of Reorganizations to Avoid the $50,000 Limit

ASCS has no central source of data on either the number of new persons approved for payment limitation purposes or the number of new persons resulting from farm reorganizations. Accordingly, we devised our own methodology to obtain the data necessary to determine the number of new persons paid in 1984-86 as a result of reorganizations to avoid the $50,000 limit.

We matched ASCS's computerized producer payment and address files for crop years 1983 through 1986 to identify a universe of new persons paid for the first time in 1984-86 and randomly selected 1,800 new persons (600 in each year) being paid in 1984, 1985, and 1986. We sent questionnaires to the 986 ASCS county offices making payments to these persons to determine whether these were new persons receiving payments as a result of a reorganization or for other reasons such as the inheritance of an existing farm. If a new person were paid as a result of a reorganization, we asked ASCS county offices to supply actual payment information to allow us to determine if any other person(s) involved in that farming operation received $40,000 or more in payments subject to the payment limitation the previous year. Where these conditions existed, we counted the new person and their payments as resulting from a reorganization to avoid the $50,000 payment limitation.

In our analysis, we used $40,000 as the point where farmers might begin to reorganize their operations in anticipation that they would reach the $50,000 limit in future years due to increasing per unit deficiency and diversion payments and increasing crop yields.

It was not GAO's purpose to prove that the intent of these reorganizations was to avoid the payment limitation. However, these reorganizations did have the effect of avoiding the limit because the addition of

new persons, each with a new $50,000 limit, allowed total payments to exceed what could have been paid without the new persons.

Impact on Fiscal Year 1987-89 Costs If the Trend in Reorganizations Related to the $50,000 Limit Continues

To determine the impact on fiscal year 1987-89 costs if the trend in reorganizations related to the $50,000 limit continues, we estimated the number of new persons resulting from farm reorganizations from 1987-89 and the payments these persons would receive.

To estimate the number of new persons resulting from farm reorganizations from 1987-89, we first determined the total number of persons who would reach the $50,000 payment limit and therefore have an economic incentive to reorganize. Our estimation of the payments for 1987-89 are based on built-in program changes in the Food Security Act of 1985 and the USDA budget documents for those years. We assumed that program participation and crop yields would remain constant at the 1986 level.

We used $50,000 during this period rather than $40,000 because program payment growth will slow after 1986 because of changes in the 1985 law, and persons will have an economic incentive to reorganize only when they reach $50,000, not in anticipation of higher payments in future years. After determining the number of persons receiving $50,000 or more, we estimated the number that would reorganize, based on trend data developed from our questionnaire. We assumed that the trend would remain constant at the 1984-86 level.

Specifics about the statistical sample and estimation methodologies we used, along with the sample results and upper and lower bounds for the estimates included in this report, are discussed separately in our report, Farm Payments: Farm Reorganizations and Their Impact on USDA Program Costs (GAO/RCED-87-120BR, April 1, 1987).

Changes Needed to Prevent Legal Avoidance of the Payment Limit

To identify the changes needed in existing law and regulations to prevent the avoidance of the $50,000 payment limitation, we

- analyzed the types of reorganizations identified in our random sample of 1,800 new producers in 1984-86 and in our work at the ASCS county offices that resulted in the avoidance of the payment limit;
- identified the provisions in existing law and regulations that allowed these reorganizations; and

- determined how these provisions could be changed to eliminate the advantages of these types of reorganizations for payment limitation purposes without interfering with the farmers' need to reorganize for tax, estate planning, and other legitimate business purposes.

We then used this information to analyze, comment on, and suggest changes to the Secretary of Agriculture's March 10, 1987, report to the Congress which recommended changes to the payment limitation. The Secretary's recommendations were made in response to a requirement included in the Joint Resolution Making Appropriations for Government Agencies for the Fiscal Year 1987, Public Laws 99-500 and 99-591.

Compliance With Existing Law and Regulations

To determine if ASCS is complying with existing law and regulations in administering the payment limitation, we reviewed 64 person determinations made for the 1986 program year at seven ASCS county offices in four states. Because of time constraints imposed by the requesters' needs, we evaluated these cases using the same information that ASCS used to make its decisions. We did not determine what other information was available to ASCS, if it had asked, nor did we determine if the farm reorganizations were carried out as planned.

ASCS does not maintain summary statistics on the number of person determinations made at the county level as a result of reorganizations. Therefore, we chose counties for review from among those with the greatest potential for reorganization by selecting counties with a large number of producers receiving $40,000 or more in 1985 and new producers paid in 1986.

At the seven county ASCS offices, we randomly selected for review person determinations that resulted in both an increase in the number of persons paid in 1986 and at least one new person being paid in 1986. The only exceptions were at two county ASCS offices in California. In the first, we randomly sampled 30 determinations that resulted in new persons in 1986, whether or not this represented an increase in the number of persons paid because person determinations in this county involved many new persons who had not participated in the program before. At the other California ASCS office, we limited our review to three determinations that the County Executive Director considered to be reorganizations specifically undertaken to avoid the payment limit and two determinations that we selected at random. Our work at the second county was limited to meet the requesters' time constraints.

We also utilized the results of a recent audit of the payment limitation by the USDA Office of the Inspector General. The Inspector General reviewed 371 farming operations involving 1,059 person determinations made at 30 ASCS county offices within seven states. The Inspector General reviewed the decisions made by the ASCS offices based on the information obtained by these offices, additional information that would have been available to these offices if they had asked, and additional information on the actual operations of the farms.

We conducted our review from July 1986 through April 1987 at the ASCS Headquarters in Washington, D.C., the ASCS Kansas City Management Office, the USDA Office of Inspector General's Southwestern Regional Office in Temple, Tx., and at various ASCS state and county offices.

We made our review in accordance with generally accepted government auditing standards except that we did not independently verify the accuracy of ASCS computerized files or the work performed by the USDA Inspector General. We did, however, consider known limitations in the data files and reconciled discrepancies that would impact our analysis.

We discussed this report with ASCS officials, who generally agreed with its contents. However, as agreed with the requesters, we did not obtain official agency comments on a draft of this report.

Chapter 2

Farm Reorganizations Are a Growing Problem That Increases Program Costs

Farm reorganizations among producers receiving payments at or near the payment limit allow producers to avoid the payment limit and increase program costs. Because of built-in program changes since 1983, a greater number of producers can and will receive payments at or near the payment limit in each year through 1989. These producers have an economic incentive to reorganize and add new persons, who can qualify for up to $50,000 per person, to their farming operations. As more and more producers near or meet the limit, the number of new persons from farm reorganizations among those producers can increase correspondingly. We estimate that by 1989 such reorganizations could result in about 31,300 new persons receiving about $900 million annually. Further, we estimate cumulative additional payments resulting from these reorganizations could total $2.3 billion for 1984-89.[1]

Factors Influencing the Increased Number of Producers Nearing the Payment Limit

The number of producers at or near the payment limit has increased because of higher per-unit deficiency payment rates and generally higher crop yields over the past few years. One way to illustrate the effect of this is to calculate the average acres that must be planted to major program crops to reach the $50,000 payment limit. As shown in figure 2.1, the acreage needed to reach the $50,000 payment limit on a corn farm has decreased by about 800 acres, or 51 percent, from 1983 to 1987, based on nationwide average crop yield and compliance with the mandatory minimum program requirements.[2] For wheat, the corresponding decline is about 1,000 acres, or 44 percent. The acreage needed to reach the payment limit for cotton and rice has also declined, although not as sharply, by 20 percent and 13 percent, respectively.

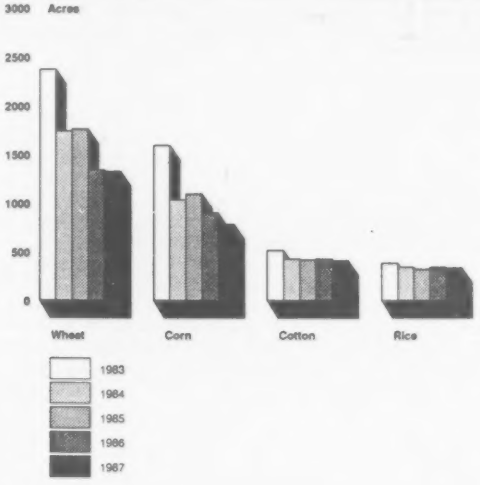
Farm Reorganizations Increased Rapidly During 1984-86

An increasing number of producers reorganized their farm operations as they neared or met the payment limitation from 1983-85. As a result, in each succeeding year, 1984-86, there was a corresponding increase in the number of new persons paid. As producers reorganize their farm operations in a manner that results in new persons, total payments from USDA can increase because each new person created by the reorganization qualifies for a separate $50,000 payment limit. Although it is not possible to prove that all of these producers reorganized to avoid the payment limit, that was the effect. Anecdotal evidence that we obtained

[1]The information in this chapter was originally reported in detail in our report Farm Payments: Farm Reorganizations and Their Impact on USDA Program Costs (GAO/RCED-87-120BR, April 1, 1987).

[2]Mandatory minimum program requirements are those that a participating farmer must comply with in order to receive government program benefits such as deficiency payments. In 1986, for example, corn farmers had to reduce the amount of acres they planted by 17.5 percent in order to receive deficiency payments on their remaining crop production.

Figure 2.1: Acreage Needed to Reach the $50,000 Limit



from state and local agricultural officials, producers who reorganized, and other sources also indicates that avoidance of the payment limit was the driving force in at least some of these reorganizations.

For 1983-85, we assumed that $40,000 in payments was the point at which a person might reorganize a farming operation in anticipation of increased payments because of built-in program changes. For example, the corn deficiency payment rate increased about 130 percent from 21 cents per bushel to 48 cents a bushel between 1983-85 because of increased target prices in the law. On a hypothetical 1,591 acre corn farm, payments would have increased by 46 percent from $50,000 in 1983 to $72,855 in 1985 based on nationwide average crop yields and compliance with required acreage reduction programs. Therefore, we assumed that producers receiving $40,000 or more in 1983-1985 had an

economic incentive to reorganize in a manner that would add new persons to their operations and increase their payments. When this ocurred, we assumed the reorganization was related to the payment limitation.

In crop years 1983, 1984, and 1985, respectively, 4,306, 14,356, and 28,678 producers received payments totaling $40,000 or more. We estimate, based on our statistical sample, that about 1,400, 1,900, and 5,700 new persons, respectively, were created in the following crop years as the result of farm reorganizations among those producers.

Farm Reorganizations Could Increase During 1987-89

For the years 1983-85, producers could maximize their payments by reorganizing their operations once payments were at or greater than $40,000 because of high program payment growth during those years. However, payment growth will slow after 1986, pushing fewer operations automatically into higher payment ranges. For example, the corn deficiency payment rate will continue to increase from 1986-88, but it will do so at a slower rate — 56 percent compared with 130 percent for 1983-85. This higher rate will also be offset, to some extent, by increased acreage reduction requirements. As a result, payments on the hypothetical 1,591 acre corn farm should increase about 39 percent from 1986-88 compared with 46 percent in 1983-85. Payment growth should slow even more for the other major crops subject to the limit, but there will still be a slight increase in payments for these crops from 1986-88. Therefore, we assumed that for the years 1987-89, producers will have an economic incentive to reorganize only when payments actually reach $50,000, not in anticipation of higher payments in future years. After determining the number of producers receiving $50,000 or more in 1986-88, we estimated the number that would reorganize in 1987-89, based on the trend in reorganizations among producers with an economic incentive to reorganize in 1983-85.

We estimate that the number of producers receiving $50,000 in payments will be about 37,600 in crop year 1986, 39,400 in crop year 1987, and 41,300 in crop year 1988. We also estimate that the farm reorganizations among these producers will increase in each of the following years resulting in about 7,100, 7,400, and 7,800 new persons respectively in 1987-89.

Total New Persons Resulting From Reorganizations Related to the Payment Limitation in 1984-89 and Their Annual and Cumulative Program Payments

We estimate that about 31,300 new persons could be paid approximately $2.3 billion as a result of farm reorganizations related to the payment limitation during 1984-89, with these new persons receiving about $900 million in 1989. Figure 2.2 shows the year-to-year changes in the estimated annual and cumulative number of new persons from 1984-89, and figure 2.3 shows the annual and cumulative payments to these new persons during the same time period.

Figure 2.2: Number of New Persons Resulting From Reorganizations Related to the Payment Limitation, 1984-89

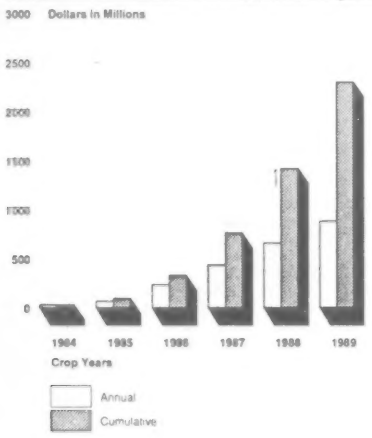
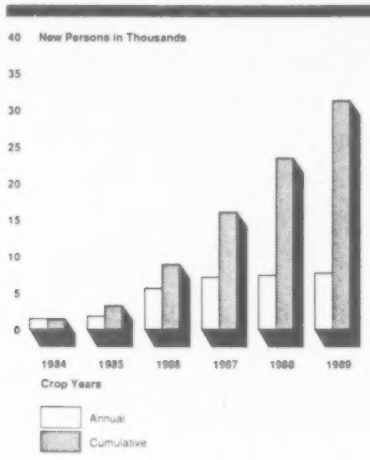


Figure 2.3: Total Annual and Cumulative Payments to New Persons Resulting From Reorganizations Related to the Payment Limitation, 1984-89



Chapter 3

Current Law and Regulations Make It Relatively Easy to Avoid the Payment Limit

Under existing law and regulations, producers can avoid the $50,000 payment limitation by reorganizing their farming operations in a manner that results in new persons for payment limitation purposes. The most frequent methods used to avoid the payment limit were for two producers who are already at the payment limit to form a corporation which qualifies for its own $50,000 payment limit or by adding a new member, who may or may not be actively engaged in the actual farming operation, to a joint venture or partnership. While the rules relating to corporations and joint operations were used most frequently to avoid the payment limit, other rules, such as the basic definition of who or what constitutes a person, were also used. For any one farming operation, these methods of avoiding the payment limit usually result in the addition of only one or a few new persons because total payments for each operation are effectively limited by the amount of acreage farmed and crop yield. However, these and other methods of avoidance, such as the division and lease of land, can result in significant increases for any one farming operation.

Use of Corporation and Joint Operation Rules to Avoid the Payment Limit

We found that it is relatively easy to increase the number of persons for payment limitation purposes by incorporating. The Secretary of Agriculture, as required by the Agriculture and Consumer Protection Act of 1973 (Public Law 93-86), defined a corporation as a separate person if no stockholder owns or controls more than 50 percent of the stock. In addition, each corporation is considered a separate person from any other corporation provided the same two or more individuals do not own or control more than 50 percent of the stock in the corporations. By using a combination of two stockholders per corporation, each of whom owns exactly 50 percent of the stock, three individuals—A, B, and C—can form three corporations—AB, BC, and AC. The three individuals and three corporations would then qualify for a total of six payments.

Joint operations, such as general partnerships or joint ventures, can also be used to increase the number of new persons on a farming operation. ASCS regulations provide that the individual members of a joint operation, not the joint operation, are separate persons. To qualify as a separate person with a separate $50,000 payment limit, each member must make contributions of either capital, land, equipment, labor, or management to the joint operation in proportion to their share of the payments from the joint operation. As a result, joint operations can increase the number of payment limits for their operations simply by adding additional members, even if those members are not actively engaged in the

actual farming operation. For example, a four member general partnership can increase the payment limits for its operation from four to five (e.g. from $200,000 to $250,000) by adding a fifth general partner, provided the fifth partner's share of the payments is in proportion to that partner's contributions to the partnership, which may consist only of capital.

The following actual example illustrates how a six-member joint venture increased the payment limit for its operation from $300,000 in 1985 to $1,050,000 in 1986 by forming a series of corporations and entering into a new joint venture with the corporations. In 1985, as shown in figure 3.1, the six-member joint venture consisted of a father and his five adult children, each of whom qualified as a separate person with a $50,000 payment limit or a total of $300,000 for the joint venture.

In 1986, the father and his children formed 15 new corporations, each of which is owned on a 50/50 basis by two of the six individuals and qualifies as a separate person with a $50,000 payment limit. As shown in figure 3.2, the family members reorganized their farming operation by forming a new joint venture, consisting of 21 persons—the six individuals and the 15 corporations—with a combined payment limit of $1,050,000.

Other Rules That Contribute to the Avoidance of the Payment Limit

While the provisions relating to corporations and joint operations have been used most often to avoid the payment limit, other ASCS rules also have been used. These include the basic definition of who or what constitutes a person and rules relating to minor children, custom farming, substantive change, and entities with common ownership.

Basic Definition of a Person for Payment Limitation Purposes

The basic definition of a person for payment limitation purposes is any individual or legal entity that (1) has a separate and distinct interest in the land or crop, (2) exercises separate responsibility for that interest, and (3) is responsible for farming costs related to the interest from a fund or account separate from that of any other individual or entity.

This definition allows avoidance of the payment limit through the division of land into parcels that earn payments at or near the limit and the cash lease of these parcels to investors not otherwise engaged in farming. The investors' involvement in farming can be limited to investing

Figure 3.1: Corporate Case Study-1985 Organizational Structure

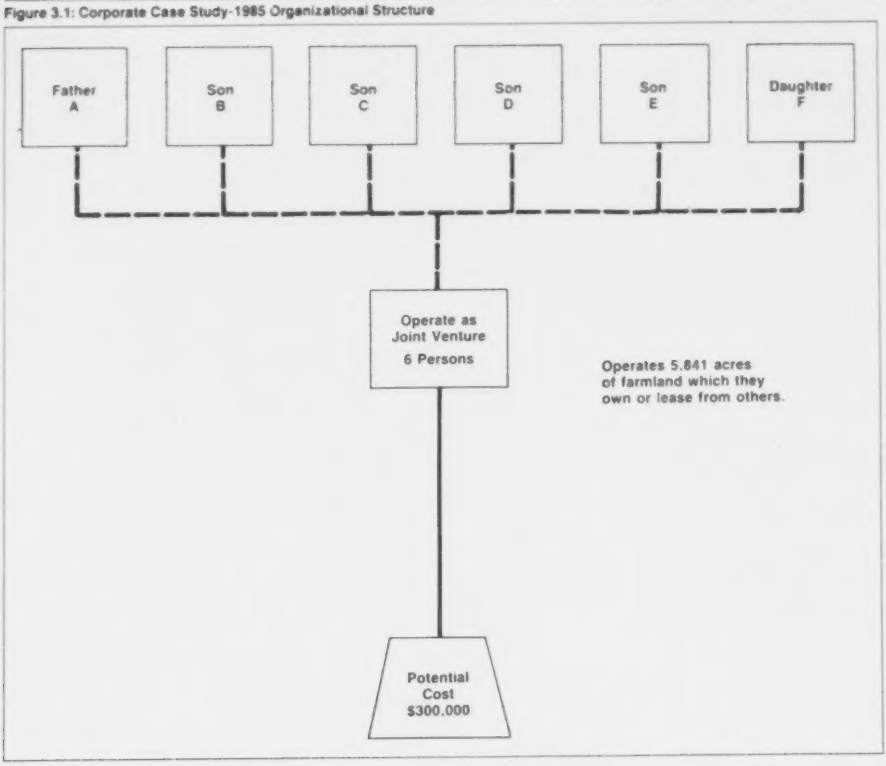


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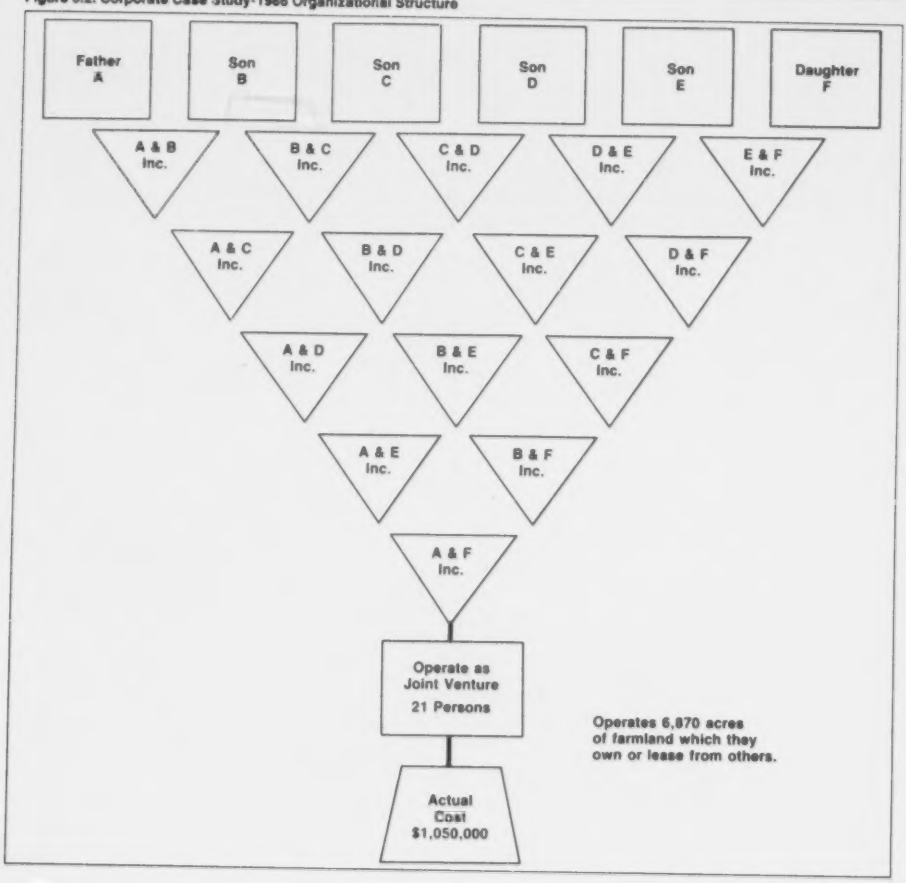
Figure 3.2: Corporate Case Study-1986 Organizational Structure



capital and signing agreements to lease the land, rent equipment, and hire management and labor. In some cases, the investors borrowed the investment capital using the anticipated crop or government payment as collateral. This type of reorganization can result in a significant increase in the number of new persons and the payment limit for an operation. For example, we found one instance where a management firm used this method to increase the payment limit from $50,000 to $1,400,000 by leasing land it managed to 28 investors.[1] The organization of this farming operation is illustrated in figure 3.3.

Minor Children

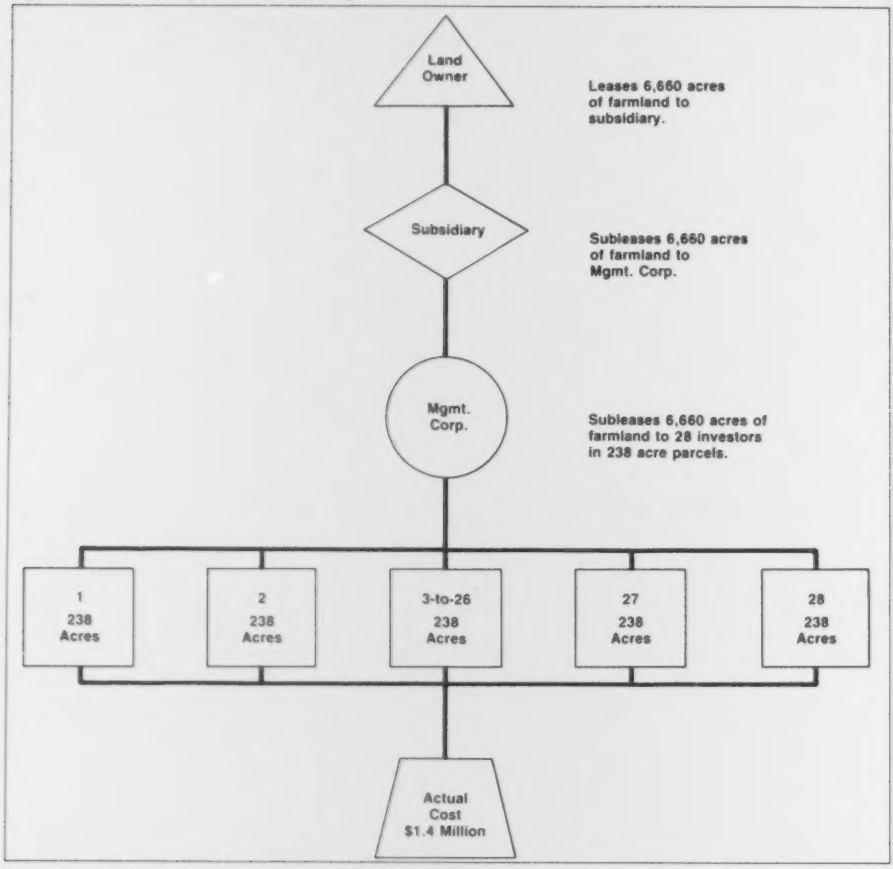
ASCS regulations require that minor children 17 years of age or younger be combined with their parents and treated as one person for payment limitation purposes. However, minor children can qualify as separate persons if they have a farming operation and a residence or guardianship separate from their parents. In its March 10, 1987, report to Congress on the payment limitation, USDA noted that parents were establishing separate residences for the children or relinquishing legal guardianship so that their minor children could qualify as separate persons for payment limitation purposes. In fact, in the previous example, shown in figure 3.3, two of the 28 new persons were minor children, 10 years old.

Custom Farming

Custom farming is the hiring of others to perform services on a farm, such as harvesting a crop, on a unit of work basis (e.g. $100 per acre harvested). In its report to the Congress regarding the payment limitation, USDA described the following situation involving custom farming. An individual rented a portion of his land to four individuals who had not farmed before. He then formed a corporation with the four individuals and transferred ownership of his equipment to the new corporation, which custom farmed for himself and the four new individuals. The original individual and the four new individuals qualified as producers and separate persons, even though the corporation was farming the land. This effectively increased the number of persons for payment limitation purposes from one to five and the total payment limit from $50,000 to $250,000.

[1]As discussed further in Chapter 4, ASCS subsequently disallowed this increase on the basis of information we developed but stated that this type of reorganization, if done properly, is legal.

Figure 3.3: Division and Lease of Land Case Study



Substantive Change

A substantive change in operations is required in any farm reorganization that increases the number of persons with separate payment limits. ASCS payment limitation rules identify several actions that constitute substantive change, including a 20-percent increase or decrease in the land involved and a change from share lease to cash lease or vice versa.[2] Therefore, operations which are incorporating or adding new members can meet the substantive change rule by simply reducing the amount of land farmed or, if land is leased, by changing the type of lease. For example, we found a case where a father and his two sons, who qualified as three persons, reorganized their operation to add three more family members for a total of six persons for payment limitation purposes. The substantive change, which ASCS officials cited as justification for the increase in persons, was a 35-percent decrease in the amount of land farmed. In effect, government program payments on this operation could double, while the amount of land being farmed declines by one-third.

Entities With Common Ownership

Because of legislative restrictions on the treatment of corporations, ASCS combines two or more corporations owned by the same two or more individuals for payment limitation purposes only when those individuals own "more than 50 percent" of the corporations. This permits the use of corporations and joint operations in the manner described on page 22 where six individuals increased payment limits for their operation to 21 by forming 15 new corporations because none of the six persons owned "more than 50 percent" of any of the corporations. The 15 new corporations would have resulted in only one additional person rather than 15, if for example, ASCS could combine entities where the same individual(s) owns "50 percent or more" rather than "more than 50 percent" of two or more entities. This would occur because each of the individuals own 50 percent of several corporations. Therefore, all of these corporations could be combined for payment limit purposes until there was only one corporate entity that qualified for a payment. There would always be that one entity remaining because the rule combines the entities with common ownership into one person for payment limitation purposes.

[2]In a cash lease arrangement, the lessee pays the land owner a fixed sum, either in cash or commodities, and retains all of the federal payments. In a share lease arrangement, the lessee shares the crop and associated federal payments with the land owner.

Chapter 4

USDA Has Proposed Changes to Reduce Avoidance of the Payment Limit, but Additional Changes Are Needed

In its March 1987 report to the Congress, USDA proposed a number of changes to reduce avoidance of the payment limit. USDA's proposals eliminate the advantage of incorporating or adding members to a joint operation to avoid the limit. USDA's proposals also include changes that will make other rules that contribute to avoidance of the limit, such as the rule for combining entities with common ownership, more restrictive. Some portions of USDA's proposal can be implemented under current legislation, while other portions require congressional action.

Overall, we believe USDA's proposals are positive actions and would be more effective than other options suggested for reducing avoidance of the payment limit. We also believe that with certain revisions, USDA's proposals can be made even more effective. The adoption of USDA's proposals, with our suggested revisions, will discourage many farm reorganizations designed to avoid the payment limit without adversely affecting other legitimate reorganizations. However, ASCS must develop clear and precise implementing regulations and administrative guidance to assure that its county offices effectively implement the changes.

Principal Thrust of USDA's Proposals

The principal thrust of USDA's proposals eliminates the advantage of incorporating or adding members to a joint operation to avoid the limit. USDA plans to accomplish this by

- treating all entities the same, as opposed to the current situation where a corporation is one person separate from its members while a general partnership is two or more persons, depending on the number of partners;
- determining the payment limit for each entity based on the number of its members "actively engaged" in the entity's farming operation, with actively engaged defined as a significant independent contribution of capital, land, or equipment and labor or management;
- attributing payments for the entity to the individual payment limits of its members on the basis of the members' interest (ownership)[1]; and
- limiting total payments for an individual to $50,000, whether the payments are from their own farming operation or attributed to them from an entity, such as a corporation, in which they have an ownership interest.

[1] Attribution to all owners in some situations would create an unacceptable administrative burden for ASCS, especially in the case of a publicly-held corporation with hundreds or thousands of stockholders. USDA's proposal would limit attribution to those individuals owning 10 percent or more of an entity in such situations.

These changes will reduce reorganizations to avoid the $50,000 limit because individual payment limits and the number of individuals actively engaged in farming, not the type of organizational structure, will be the driving force in applying the payment limit. Specifically, these changes will reduce the advantages of (1) adding members to increase the payment limit for an entity's operation, which is now possible for joint operations, by limiting payments to the persons actively engaged in farming and (2) creating corporations that qualify as separate persons by attributing payments for an entity to the owners and counting these payments against the owners' individual payment limits.

USDA's Proposals Will Also Make Other Rules That Contribute to Avoidance More Restrictive

USDA's proposals will make the payment limitation rules for minor children, custom farming, substantive change, and entities with common ownership more restrictive. Specifically, USDA's proposals would make the following changes in these rules.

- Minor children who can now be separate persons in several situations would always be combined as one person with their parents in all situations, except when the child maintains a separate household and carries out the actual farming operations on a farm in which the parents have no interest.
- Individuals or entities who use the same custom farming organization and who are now separate persons would be combined as one person if the owners of the organization that does their custom farming has any interest in their land or crop.
- The substantive change rule that now allows an increase in the number of persons when there is a 20-percent increase or decrease in the land involved would be changed to require that (1) the amount of land being farmed must increase before the number of persons can increase and (2) the number of new persons added would be limited by the payments that result from the increase. For example, if enough crops are grown on the added land to qualify for an additional $100,000 in payments, only two new persons—each with a $50,000 limit—could be added. In addition, the rule that now allows an increase in the number of persons in a reorganized farming operation when a different land lease arrangement is used would be changed to allow an increase in the number of persons only if the new person(s) is the landowner and the change is from a cash to a share lease arrangement.
- Finally, the rule for combining entities with common ownership would be changed so that entities will be combined as one person when the same one or more individual(s) owns or controls 50 percent or more of

the entities[2], rather than when "the same two or more" individuals own or control "more than 50 percent" of the entities.

ASCS can implement all of these changes under its existing legislative authority, except the rule for combining entities with common ownership. However, ASCS officials stated that they did not want to make any of these changes until the Congress reaches a consensus about what changes ASCS should make. ASCS can change its rules for combining entities with common ownership only if the Congress removes the legislative restriction on the treatment of corporations for payment limitation purposes.

Changes in Law Necessary to Implement USDA's Proposals

Before ASCS can implement USDA's proposal, the Congress will have to (1) eliminate existing legislative requirements on the treatment of corporations for payment limitation purposes and (2) authorize payment limits for legal entities based on the number of their members actively engaged in the farming operation. Under existing legislation, ASCS must consider a corporation as a separate person for payment limitation purposes provided that

- no stockholder owns more than 50 percent of the corporation's stock, otherwise the corporation and the stockholder are combined as one person, and
- the same two or more stockholders do not own more than 50 percent of two or more corporations, otherwise the corporations with common ownership are combined as one person.

This restriction effectively prevents ASCS from changing the manner in which a corporation is treated for payment limitation purposes. The Congress would also have to authorize the determination of payment limits for entities on the basis of the number of members actively engaged in the entities' farming operations, as existing law does not provide for this. USDA's proposal includes a suggested amendment to the Food Security Act of 1985 to make these legislative changes (see appendix VI).

[2]USDA's proposal actually states, however, that this will occur when two or more persons own 50 percent or more of the entities, but ASCS officials intended for this to read as shown above.

USDA's Proposals Still Have Some Loopholes

USDA officials stated that they intended that total payments to any individual would be limited to the $50,000 limit established in law, whether these payments were from the individual's own farming operations or attributed from legal entities in which the individual shares ownership. However, we found that USDA's proposed amendment to the Food Security Act of 1985 will not limit payments attributed to a member of an entity if the entity qualifies as a separate person under the current rules unless these individuals have other farming interest outside of the entity.

For example, four individuals form a corporation to operate a farm on which 3 of those persons meet USDA's definition of actively engaged in farming. The three individuals, who are actively engaged in the corporation's farming operation, also have farming interests of their own outside the corporation that qualify them as separate persons, but the fourth individual does not. Under USDA's proposal the corporation will qualify for up to $150,000 in payments ($50,000 x 3 members actively engaged in farming). The payments will then be divided among the 4 owners of the corporation ($37,500 each). The three owners who are considered as persons for payment limitation purposes have individual $50,000 per person payment limits. However, under the proposed and current rules the fourth owner, who has no farming interest outside the corporation, does not qualify as a person and does not have an individual payment limit because he does not have a separate interest in the crop which is one of the basic requirements under the rules. In this case the corporation would be considered to have the only interest in the crop. The reason the other three individuals have a payment limit is because they have other farming interests where they have a separate interest in the crop. As such, the fourth individual could own portions of a number of corporations and receive payments from those corporations in excess of $50,000. ASCS can correct this problem by including these individuals in its definition of a person.

We also found that USDA's proposals do not address avoidance of the payment limit through the division and lease of land to investors not otherwise engaged in farming. Therefore, individual investors like those in the example discussed on page 25 will continue to qualify as separate persons, even though their only contribution to farming may be investment capital, which in some instances comes from a loan secured by the government payments they are receiving on the farming operation. USDA could have addressed this method of avoidance by applying its proposed definition of actively engaged in farming to individual producers as well as members of an entity.

ASCS officials did not apply the proposed definition of actively engaged in farming to individuals because this would preclude payments to land owners who share rent their land. However, ASCS can reduce avoidance of the limit through the division and lease of land without impacting these land owners by requiring that the person leasing land but not the land owner also make a substantive contribution of owned-land or owned-equipment and personal labor or active management in addition to capital to the farming operations that include the leased land.

Other Options to Reduce Avoidance of the Payment Limitation Are Less Effective Than Those Proposed by USDA

Several other options to reduce avoidance of the payment limit have been suggested by Members of the Congress, their staffs, the USDA Inspector General, and others concerned about this problem. These options include (1) applying a $50,000 payment limit to each legal entity and attributing each owner's share of that payment against their individual payment limits, (2) combining owners of a legal entity as one person with the entity, (3) defining only individuals as persons, and (4) increasing the payment limit.

We believe these options would be less effective than USDA's proposal for reducing avoidance of the payment limit, primarily because they would likely cause an increase in other types of reorganizations. In some cases program costs would not necessarily rise, but the increase in reorganizations would be an unnecessary administrative burden on ASCS.

Except for increasing the payment limit, each option requires that the Congress remove the legislative restriction on how a corporation is treated for payment limitation purposes. In evaluating these options, we assumed that ASCS would change the rules for minor children, custom farming, substantive change, and combining entities as proposed by USDA.

Apply a $50,000 Limit to Each Legal Entity and Attribute That Payment to the Owners' Payment Limits

Under this option, ASCS would establish a two-tier payment limitation when legal entities other than individuals are involved. This option is very similar to USDA's proposal. The only difference is that, under this proposal, each entity would have one $50,000 payment limit regardless of the number of its members actively engaged in its farming operations. Payments up to this limit would then be attributed to the owners of the entity and count against their individual payment limits.

This option would remove the advantages of incorporating or adding new members to a joint operation. However, it would increase the

number of reorganizations because members of a joint operation who are now separate persons would have an economic incentive to dissolve the joint operation and farm separately as individuals. For example, payments which now total $200,000 to a four-member general partnership would be limited to $50,000 under this proposal. As a result, the members would have an economic incentive to dissolve the partnership and farm separately to continue receiving $200,000.

Combine Owners of a Legal Entity as One Person With the Legal Entity

Under this option, ASCS would basically combine all legal entities with the owners of those entities for payment limitation purposes. It would remove the advantages of incorporating or adding new members to a joint operation. However, members of these entities who now qualify as separate persons would be combined with the entities as one person, and as a result, they would also have an economic incentive to dissolve the entity and farm separately as individuals. The four members of the partnership discussed in the previous example would be limited to $50,000 in payments under this proposal unless they dissolved the partnership and farmed separately.

Define a Person as Individual Producer Only

Under this option, ASCS would not include any legal entity other than an individual in its definition of a person, and payments would be made only to producers who are individuals. Its application would pose legal problems because legal entities do qualify as producers and are entitled to receive payments. However, even if the legal questions involved in its application could be resolved, the proposal would interfere with the ability of individual producers to reorganize their operations as legal entities for tax, estate planning, or other legitimate business reasons if those entities could not receive payments. In addition, individuals involved in existing entities would be encouraged to dissolve those entities and operate as individuals so they could receive payments.

Increase the Payment Limit

An increase in the payment limit would decrease the number of producers affected by the limit and, as a result, the number of farm reorganizations to evade the limit would probably decrease. Program costs would increase because less than 20 percent of producers with an economic incentive to reorganize (those at or near the limit) do so, and payments to those producers who do not reorganize would automatically increase. The amount of increase for each producer would depend on the extent to which the payments the producer is eligible for exceed the current limit and the amount of the new limit. In addition, the economic incentive to

avoid the limit would still exist for those affected by the new higher limit, and some portion of these persons would probably reorganize.

Clear Regulations and Guidance Required to Implement USDA's Proposals

If USDA's proposals are adopted by the Congress, ASCS will need to develop clear and precise regulations and guidance for its county offices to assure their effective implementation. ASCS county officials, who make the person determinations for payment limitation purposes, will then have to determine how many members of an entity are actively engaged in the farming operation based on the number of members who make significant independent contributions of capital, land, equipment, labor, or management to the entity's operation.

ASCS will need to define what a significant independent contribution is and how to value land, equipment, labor, and management for this determination. Currently, as discussed in Chapter 5, ASCS does not provide adequate guidance to its county offices for similar determinations under existing payment limitation regulations.

Further, ASCS will need to be explicit as to what labor and management contributions are acceptable. Otherwise, an individual can contribute capital in an amount that meets the criteria established for a "significant independent contribution" and then complete the necessary requirements to be considered "actively engaged" by providing only a few days labor or brief consultations for management purposes. In one instance, for example, we found three family members who claimed to share equally in the management of a general partnership. However, this is hard to accept when one of them lived in Australia, another lived over 100 miles from the land being farmed, and the third was paid to provide the day-to-day management of the farming operation.

Chapter 5

ASCS Needs to Improve Its Administration of the Payment Limitation

ASCS county offices determine which individuals and entities are separate persons for payment limitation purposes based on a farm operating plan provided by producers and applicable rules and regulations. This determination is fundamental to the effective administration of the payment limitation provisions.

In separate reviews, GAO and the USDA Inspector General found that ASCS county officials incorrectly applied or failed to obtain information necessary to correctly apply payment limitation regulations in over 20 percent of the person determination cases reviewed. In addition, although required to, county officials did not always verify that reorganized farming operations resulting in new persons were carried out as planned.

These incorrect determinations occurred primarily because of inadequate guidance and training on how the regulations should be implemented and ineffective internal control procedures to ensure correct implementation of the regulations. During 1986, ASCS took some actions that should improve person determinations made for the 1987 and later program years. These changes include revising some program guidelines and increasing training. However, ASCS needs to further improve its guidance and training on implementation of the regulations as well as its internal controls.

Results of Reviews of County Office Operations

We reviewed 64 person determinations for program year 1986 and questioned 29 determinations that resulted in 70 new persons and potential overpayments of $2.4 million. We questioned 11 determinations because they were incorrect based on the available information. These 11 determinations resulted in 20 new persons and potential overpayments of $413,000. We questioned the remaining 18 determinations because they were made without adequate information to make a proper determination.

Because of time constraints, we did not verify these determinations against the actual farming operations of the individuals and entities involved. If we had done so, it is likely that some of the determinations made without adequate information may have been correct. However, it is important to note that county officials would not have known this at the time they made the determinations because they did not have the necessary information to make the determinations. We did, however, request that ASCS obtain additional information about one determination made without adequate information that involved the division and lease

of land to 28 investors not otherwise involved in farming. On the basis of this information, ASCS headquarters officials determined that none of the investors were eligible for payments and initiated actions to collect about $1.4 million in payments subject to the limit.

In addition to our review, the USDA Inspector General reviewed 1,059 person determinations made between 1981 and 1986 and found 225 in error that resulted in overpayments of $15.7 million. The Inspector General went a step further than we did and reviewed the actual farming operations of the individuals and entities involved in these determinations. On the basis of these reviews, the Inspector General found that the determinations were in fact erroneous.

Need for Improved Guidance

We found that the regulations that were incorrectly applied or applied without sufficient information involved requirements that (1) a substantive change be made in the farming operation when a farm reorganization results in a new person for payment limitation purposes, (2) each person's financing be separate and distinct, and (3) payments to a person who is a member of a joint operation be commensurate with that person's contributions to the joint operation. The USDA Inspector General found that custom farming and other rules also were incorrectly applied. These rules are important factors in determining whether separate persons exist for payment limitation purposes. We found that the ASCS guidance to its county offices was generally inadequate or vague about how these factors should be considered in person determinations. In addition, ASCS guidance about the information needed to make a person determination and how to verify that reorganized farming operations were carried out as planned was also inadequate.

Substantive Change

ASCS requires that the change in farming operation be "substantive" if the reorganization results in new persons for payment limitation purposes. However, ASCS guidance is vague about the nature or extent of change required to meet this criteria. For example, ASCS guidance for the 1986 program year provided that

- a "substantial" change in farm size by purchase, sale, or lease of land is a substantive change, but the guidance did not include criteria on specifically what constituted a substantial change;
- transfer of ownership for equipment or land from an existing person to a new person can constitute substantive change but did not specify how much equipment or land must be transferred; and

- a "paper change" in which essentially the same individuals or legal entities continue to farm the same land with the same equipment is not a substantive change but did not clarify whether this rule applies when the ownership of some or all of the land or equipment changes among the individuals and entities involved.

As a result of the vague guidance, ASCS county officials interpreted substantive change differently. For example, officials in one county considered the addition of a new individual to an operation as a substantive change, while officials in another county required a 20-percent increase in land.

The effect of such differing interpretations is illustrated by the following reorganization. In 1985, five individuals and a corporation owned by two of the individuals had six separate farming operations involving 8,900 acres. In 1986, these individuals reorganized their operations into 10 separate operations by creating four new corporations among themselves and by leasing approximately 2 percent more land. In the county that required a 20-percent increase in land, the new organization would have been determined to be six persons receiving $300,000 in payments. In the county where the reorganization occurred and where a 20-percent increase in land was not required, the reorganization resulted in 10 persons receiving $452,000.

In total, ASCS county officials incorrectly determined or failed to obtain sufficient information to determine if a substantive change occurred in 8 of the 29 person determinations we questioned. The Inspector General found no substantive change in 141 of the 225 determinations questioned.[1] ASCS has issued revised guidelines which should improve the application of the substantive change rule in future program years.

Financing

The basic definition of a person for payment limitation purposes requires that a person finance his or her operation separately from any other person. ASCS headquarters interpreted this requirement to preclude any individual or legal entity with an interest in the new person's farm or crop from providing financing in any manner including making, co-signing, or providing collateral for a loan or paying operating expenses of the new person. ASCS headquarters provided county offices

[1]The number of determinations noted as being in error for each type of error discussed in this section, if added together, will exceed the total determinations found to be in error. This is because some erroneous determinations involved more than one type of error.

with little guidance on their interpretation of this requirement for the 1986 or prior year programs.

California state ASCS officials incorrectly interpreted this rule during 1986 for members of a general partnership or joint venture by allowing common assets to be pledged as security for operating loans of individual members. We reviewed 13 person determinations involving partnerships or joint ventures in California and found that three were in error because of this incorrect interpretation. As a result, nine persons were overpaid $206,000. The ASCS Executive Director in the county where these errors occurred estimated that as many as 50 percent of their determinations for partnerships or joint ventures could be in error because of the incorrect interpretation of the financing rule.

In total, ASCS county officials incorrectly determined or failed to obtain sufficient information to determine if financing was separate in 18 of the 29 person determinations we questioned. Similarly, the Inspector General found that financing was not separate in 99 of the 225 determinations questioned. ASCS has revised its guidance on financing beginning with the 1987 program year but does not intend that the revised guidelines be used to collect overpayments in prior years because in their view it would be unfair to the producers because it was ASCS' error.

Commensurate Shares

ASCS guidance provides that members of joint operations, such as general partnerships, are separate persons provided each member involved in the joint operation contributes capital, land, equipment, labor, or management in proportion to (commensurate with) their share of the payments. However, no guidance is provided about how to evaluate, for example, contributions of labor and management to determine if the contributions are commensurate with the payments received.

ASCS headquarters' interpretation of this requirement is that if the assets of a joint operation are used to produce the crop, then the contribution of each member in the joint operation is equal to the member's share of ownership and consequently should be equal to his share in the payments in the joint operation. If any of the members contributes additional capital, land, equipment, labor, or management to the production of the crop, then the value of this additional contribution must be added to that member's share of ownership to determine whether the member's share of the payments is commensurate.

In total, nine of the 29 determinations we questioned involved joint operations. In five of these cases, we found that ASCS county officials failed to obtain sufficient information to determine if members' contributions were commensurate with their payments. For example, ASCS county officials determined that members' contributions were commensurate with their share of payments even though they did not know which members contributed the land or equipment or the value of those contributions. The Inspector General also found 131 determinations in error because contributions were not commensurate with the payments received in joint operations.

Information Needed to Make a Person Determination

ASCS guidance to its state and county offices requires that they obtain whatever documentation is necessary to make the person determination. The guidance notes that the documentation may include legal documentation about land ownership, the legal entity, operating agreements, leases, financial arrangements, and any other information needed to apply the payment limitation rules. However, no guidance is provided about what information is needed to apply specific rules or how this information should be documented.

County ASCS officials were not consistent in the information or documentation they required to support approval of new persons for payment limitation purposes. Officials in one county office requested evidence of incorporation, financing, lease arrangements, and capital investment. Other offices, however, obtained little information or documentation on which to base their decisions. In one county, we found that none of the 12 determinations we randomly selected for review had sufficient documentation to support the approval of new persons. For example, the county officials did not have documentation in some cases to show who owned the land or equipment that was used by the new partnership. As a result, 11 new persons may have been incorrectly paid $392,000 in 1986. However, without the needed documentation there is no way to know.

The documentation ASCS officials accepted as evidence of a corporation's stock ownership illustrates the confusion that exists regarding what information and documentation are needed to apply specific rules. A corporation cannot be a person separate from its stockholders if any individual owns more than 50 percent of its stock. To verify the extent of individuals' ownership of a corporation's stock, ASCS county and state officials accepted letters from attorneys or stockholders, minutes of Board of Directors' meetings, and copies of stock certificates without

assurance that all outstanding stock was included. ASCS officials rarely obtained the corporation's stock transfer ledgers that would have provided the information necessary to verify ownership of the corporation's stock.[2]

In total, 24 of the 29 determinations that we questioned were made without sufficient documentation to determine that (1) a substantive change had occurred, (2) financing was separate, (3) partners' contributions were commensurate with their share of payments or (4) ownership of land, equipment, or legal entities had changed when this information was critical to the person determinations.

The Inspector General found similar documentation problems. Of the 225 person determinations the Inspector General found in error, 77 also involved county officials making person determinations without sufficient information.

Verification of Farming Operations

ASCS regulations require county officials to verify, beginning with the 1986 program year, that key aspects of reorganized farming operations resulting in new persons were implemented according to the farm operating plan because this plan was the basis for adding the new persons. However, except for one generalized example, ASCS guidance does not indicate what key aspects of a farming operation should be verified. In addition, no guidance is provided about how this should be done beyond noting that the documentation used for this purpose should include (1) evidence of how crops were marketed, bills were paid, and who did the farming and (2) legal documents to verify ownership, existence of legal entities, or other transactions.

We found that county officials did not consistently implement the verification requirement. For example, officials in two counties followed an earlier state office requirement to make a review of at least two determinations resulting in new persons or involving operations they considered suspicious. Officials in a third county requested general documentation without analyzing the determinations to identify what key information needed to be documented or what documentation was needed to support the information. In a fourth county, officials stated that they did not plan to implement this requirement. Subsequently,

[2]Most corporations involved in person determinations are family owned or closely held corporations with only a few stockholders. Review of stock transfer ledgers is not burdensome for either ASCS or the corporations in these instances, and ASCS has alternative certification procedures for publicly traded corporations where this would be burdensome.

however, they did request some information for those determinations that we questioned.

The Inspector General's review illustrates the need to verify that farming operations are carried out according to their farm operating plan—the basis for determining the number of persons who qualify for payments. For example, in some cases farmers misrepresented their source of financing or misrepresented farm employees, who continued to work for wages, as new persons in partnerships. The Inspector General found that 63 of the 225 person determinations reviewed were in error because producers did not operate in accordance with their plans.

Need for Improved Internal Controls

ASCS county officials are required to submit 10 percent of their determinations to the ASCS state offices for review, and state officials are required to submit 10 percent of the cases they review to ASCS headquarters for review to assure that person determinations are made in accordance with regulations. However, ASCS internal control procedures are inadequate for this purpose.

The fundamental fault with ASCS internal control procedures is that the determinations are selected for review by the officials whose work is, in effect, being reviewed. Therefore, ASCS management officials have no assurance that the determinations being reviewed are representative of these determinations, as required by ASCS procedures.

Further, ASCS has not established procedures to assure that the required number of determinations is submitted for review. At the suggestion of the Inspector General, ASCS required that state and county offices maintain logs of the person determinations made in 1986 to assure that the required number of determinations is submitted for higher level review. However, we found that headquarters officials and officials in three of four state offices we visited did not use this information.

Finally, ASCS has not established a systematic approach to analyze the determinations submitted for review to identify the types of errors found or to advise other offices of the results of such analyses. Only the county or state office submitting a case for review receives feedback on the cases reviewed. Other ASCS state and county offices do not receive timely information about policy decisions made in response to new types of reorganizations or common errors found in these reviews. For example, ASCS headquarters officials were aware that reorganizations were occurring with very little change in land or capital investment as early

as 1984. In response, ASCS officials began requiring that there be a 20-percent change in land and that reorganized entities have capital equal to 30 percent of their first year operating costs when reviewing and approving determinations at the headquarters level. However, almost 2 years passed before this information was incorporated into ASCS guidance for state and county offices.

Need for Improved Training

ASCS' training for its officials making person determinations is inconsistent and, as evidenced by the number of errors found in our review and the Inspector General's review, inadequate. ASCS's training program does not (1) identify who should be trained and how much training they should receive, (2) provide an approach for considering the wide variety of factors that impact person determinations, or (3) provide training materials such as a course manual for use by state officials in training county officials.

ASCS has not established minimum training requirements for officials making person determinations that identify who should be trained and how much training they should receive. Headquarters officials train state officials on an ad hoc basis and allow the state officials to determine which county officials will be trained and how much training they receive. Some state officials train all county officials involved in person determinations. Other state officials train only the County Executive Director, who then trains or advises the County Office Committee members who actually make the person determinations. This ad hoc approach to training may be part of the reason that the regulations were not being consistently applied in the state and county offices visited by us.

ASCS training provides an overview of the regulations, but it does not provide an approach for applying these regulations to the wide variety of factors that impact person determinations. For example, there is wide variance in the type and complexity of ownership arrangements, organizational structures, leasing arrangements, farming practices, and financing arrangements that must be considered when making person determinations. Different rules apply depending on which of the many possible combinations of these factors are present in a particular situation, and ASCS training does not provide a systematic approach for analyzing each situation to determine which rules apply.

ASCS also has not developed standardized training materials such as a course manual for use in training state and county officials. The need

for uniform training materials is illustrated by the fact that officials in at least one state incorrectly interpreted the financing rules and officials in another state provided incorrect training and guidance to county officials. In this second state, officials (1) described a hypothetical reorganization as not meeting the substantive change requirement when in fact it did and (2) instructed county officials to make a separate person determination for each farming operation even though all related farming operations should be considered together for person determination purposes.

ASCS has increased the amount of training provided to state officials, as discussed later in this chapter, but still has not established any specific training requirements for county officials who actually make the person determinations or developed standardized training materials to assure consistent applications of program rules.

Corrective Actions by ASCS

ASCS has recently taken some actions that should improve the person determinations made by county office officials in 1987 and later program years. These actions include improving the forms used, revising guidelines for implementing the regulations, and increasing the training provided state officials.

ASCS revised the form on which producers will provide the information used by county officials in making 1987 program year person determinations. ASCS replaced a one-page form with three new forms: a one-page form for individuals, a two-page form for joint operations such as partnerships and joint ventures where the individual members not the organization may be persons, and a two-page form for legal entities such as corporations that may be persons separate from their members. These new forms should make it easier for county officials to focus on the rules applicable to each type of organization. In addition, the new forms focus attention on factors important to the person determinations such as financing, leasing arrangements, and ownership of land and equipment.

Beginning in December 1986, ASCS also revised its guidance for state and county offices to incorporate the criteria used by headquarters officials in reviewing determinations beginning with the 1987 program year. These revisions address some but not all of the problems noted in our review. For example, the revised guidance reemphasizes the need to verify that actual farming operations were carried out as planned and improves the application of this requirement by requiring that it be done

for all determinations on a random sample basis. The revised guidance requires that determinations submitted to state and headquarters officials for review be selected randomly, but the officials being reviewed rather than the reviewing officials will continue to make the selection. Also, the revised guidance does not address such important considerations as how much equipment or land must change ownership to qualify as a substantive change, how to make the computations necessary to determine if payment shares are commensurate with actual contributions in joint operations, and the type of information and documentation needed to apply specific rules or verify that the operations were carried out as planned.

Finally, ASCS has increased the training provided to state ASCS officials, who in turn provide training to county officials. Prior to 1985 very little training was provided to state officials. ASCS provided a half day of training on the payment limitation provisions during meetings of these officials in 1985 and 1986 and more recently provided a full day of training on this subject for these officials. However, ASCS has not established minimum training requirements or developed uniform course materials these officials can use when training county officials, nor does it have any plans to do so at present.

Chapter 6

Conclusions and Recommendations

Commodity program changes have increased payments to producers and placed an increasing number of them at or near the payment limit. Provisions of the current law and regulations allow individuals and entities to reorganize their farming operations by creating corporations, adding new members to joint operations, or establishing other entities that qualify for additional payment limits and thereby avoid the limit. As a result, both the number of new persons resulting from reorganizations related to the payment limit and payments to these persons increased significantly in 1984-86. The number of producers affected by the payment limit and reorganizations among these producers could continue to increase through 1989. We estimate that as many as 31,300 new persons could be receiving almost $900 million annually by 1989 and that cumulative payments to these new persons for 1984-89 could total $2.3 billion.

USDA has proposed changes that will eliminate the advantages of incorporating and adding members to a joint operation by (1) determining the payment limit for each legal entity based on the number of members actively engaged in its farming operation, (2) attributing the entity's payments to the individual payment limits of the members based on their share of ownership in the entity and (3) limiting payments to $50,000 for individuals whether these payments are earned from their own operations or are attributed to them. USDA's proposals also include other changes that would make rules for minor children, substantive change, custom farming, and entities with common owners more restrictive. USDA's proposal also includes suggested legislative changes necessary for implementation.

We believe USDA's proposals are basically sound and will significantly enhance the effectiveness of the payment limitation. We also believe, however, that USDA's proposals could be made even more effective with some revision. Specifically, USDA's proposals should be revised to (1) address the division and lease of land to investors not otherwise involved in farming and to (2) define owners of an entity who have no separate interest in any farming operation outside the entity as a person in order to limit payments to them.

USDA's proposal does not include regulations and guidelines necessary to ensure the proper implementation of the new rules at the county office level. In addition, current ASCS guidance to county and state offices, training of officials in these offices, and internal controls over their activities are not adequate to ensure that person determinations are made properly or consistently. As a result, ASCS county officials are

making person determinations without obtaining information critical to those determinations and are making incorrect determinations based on the information they do obtain. While ASCS has taken a number of positive actions to correct this situation, additional corrective action is required whether or not USDA's proposed changes are enacted.

Recommendations to Congress

We recommend that Congress enact legislation to limit payments to legal entities and attribute their payments to the individual limits of the entities' owners. USDA's proposal includes legislation that would remove the existing legislative restrictions about how corporations are treated for payment limitation purposes and authorize ASCS to determine the payment limit for a legal entity on the basis of the number of its members actively engaged in its farming operations.

If Congress decides not to adopt the legislation proposed by USDA, we recommend that, at a minimum, Congress remove the existing legislative restriction that requires a corporation to be considered as a separate person for payment limitation purposes as long as no stockholder owns or controls more than 50 percent of its stock and as long as the same two or more stockholders do not own more than 50 percent of two or more corporations. If left in place, this restriction will allow producers to continue to reorganize under the corporate rules in a manner that avoids the limit and will prevent ASCS from making changes necessary to reduce avoidance of the payment limit.

Recommendations to the Secretary of Agriculture

We recommend that the Secretary of Agriculture direct the ASCS Administrator to make the following changes in the payment limitation provisions.

If the Congress adopts the legislative changes offered by USDA, ASCS should be required to (1) ensure that implementing regulations and guidance to its county offices specify the extent of contributions necessary to determine if a member of a legal entity is actively engaged in the entity's farming operation and how the member's contributions are to be valued for this determination, (2) change its rules to limit payments through attribution to members of a legal entity who are not now persons for payment limitation purposes, and (3) change its rules to require that a person who leases land make a substantive contribution of owned land or equipment and personal labor or active management in addition to capital for the farming operation that includes the leased land.

If the Congress does not adopt USDA's legislative proposal, ASCS should be required to (1) implement the changes included in USDA's proposal to make the payment limitation rules for minor children, custom farming, and substantive change more restrictive and (2) change its rules to require that a person, other than a landowner, in a lease situation make a substantive contribution of owned land or equipment and personal labor or active management in addition to capital.

If Congress removes the legislative restriction on the treatment of corporations, but does not implement the remainder of USDA's legislative proposal, ASCS should be required to make the rule for combining entities with common ownership more restrictive by combining all entities as one person for payment limitation purposes when the same one or more individual(s) owns or controls 50 percent or more of the entities, as well as the other changes discussed above that it can make under its existing legislative authority.

We recommend that the Secretary of Agriculture also direct the ASCS Administrator to make the following changes in ASCS's administration of the payment limitation:

- Improve ASCS guidance to state and county offices by describing (1) how much equipment or land must change ownership to justify the approval of a new person for payment limitation purposes, (2) how to value contributions by members of a joint operation to determine if those contributions are commensurate with their share of the payments, and (3) the type of information and documentation needed to apply specific rules and verify that farm operations were carried out as planned. An acceptable alternative to describing the information and documentation needed to apply specific rules or verify farming operations in its guidance would be for ASCS to include this description in the training program discussed below.
- Revise ASCS's management review system so that reviewing officials select the determinations to be reviewed, analyze these determinations to identify the emerging trends in errors and methods of reorganization, and disseminate information about needed changes identified by this analysis on a systematic and continuing basis. ASCS headquarters officials should be responsible for disseminating the results of these analyses to assure uniformity and consistency.
- Establish a training program for ASCS state and county officials involved in person determinations that (1) identifies who should be trained and

how much training they should receive, (2) sets out an approach to making and reviewing person determinations, and (3) provides standardized training materials for use by state officials in training county officials.

Appendix I

Payment Limit History

Congress established an annual $55,000 per person per crop limit for wheat, feed grains, and upland cotton in the Agriculture Act of 1970 (Public Law 91-524) to reduce program costs and to prevent producers from benefiting excessively from commodity program support payments. Payments authorized by this act included land diversion payments, wheat certificate payments, and other payments based on parity prices in use at that time.

The Agriculture and Consumer Protection Act of 1973 (Public Law 93-86) introduced the concept of target prices and deficiency payments used today and reduced the annual payment limitation for 1974 through 1977 to $20,000 per person for the combined wheat, feed grain, and upland cotton deficiency and diversion payments.

The Rice Production Act of 1975 (Public Law 94-214) imposed an annual $55,000 per person limit on payments for rice in 1976 and 1977.

The Food and Agriculture Act of 1977 (Public Law 95-113) continued to combine wheat, feed grain, and upland cotton deficiency and diversion payments, but it increased the annual per person limit to $40,000 for 1978 and $45,000 for 1979. It also limited rice deficiency payments to a separate per person limit of $52,250 in 1978 and $50,000 per person limit for 1980 and 1981.

In addition, the act provided discretionary authority for the Secretary of Agriculture to reduce the loan rate for wheat and feed grains to increase exports. However, if the Secretary reduced the loan rate, farmers were to receive compensation equal to the reduction in additional deficiency payment. These additional deficiency payments, commonly referred to as Findley Amendment payments, were not subject to the payment limitation.

The Agriculture and Food Act of 1981 (Public Law 97-98) provided for a $50,000 per person limit for wheat, feed grains, upland cotton, and rice; the authority to reduce the wheat and feed grain loan rate; and the provision for Findley Amendment payments not subject to the payment limit through 1985. In addition, the act established a separate $100,000 per person limit on disaster payments for these crops. The Extra Long Staple Cotton Act of 1983 (Public Law 98-88) amended the Agriculture and Food Act of 1981 to add deficiency and diversion payments for long staple cotton to the total payments subject to the $50,000 limit.

The Food Security Act of 1985 (Public Law 99-198) continued the payment limitation provisions of the Agriculture and Food Act of 1981 through 1990. In addition, the Food Security Act of 1985 allowed farmers to repay loans for cotton and rice at a reduced rate when the market price was less than the loan rate. The subsidies represented by the difference between the loan and repayment rates were referred to as a marketing loan and were not subject to the $50,000 per person limit.

In October 1986, Congress amended the Food Security Act of 1985 to establish a new $250,000 limit. The new limit did not change but included the existing $50,000 per person limit for deficiency and diversion payments. Other payments subject to the $250,000 limit include disaster payments and various payments not previously subject to a payment limitation such as Findley Amendment payments and marketing loans. The payment limitation provisions of the Food Security Act of 1985, as amended, are included as appendix II.

Appendix II

Section 1001 of the Food Security Act of 1985, as Amended

Note: GAO comment supplementing those in the report text appear at the end of this appendix

Sec. 1001. Notwithstanding any other provision of law:

(1) For each of the 1987 through 1990 crops, the total amount of deficiency payments (excluding any deficiency payments described in paragraph (2)(B)(I)(iv) of this section) and land diversion payments that a person shall be entitled to receive under one or more of the annual programs established under the Agricultural Act of 1949 (7 U.S.C. 1421 et seq.) for wheat, feed grains, upland cotton, extra long staple cotton, and rice may not exceed $50,000.

(2)(A) For each of the 1987 through 1990 crops, the total amount of payments set forth in subparagraph (B) that a person shall be entitled to receive under one or more of the annual programs established under the Agricultural Act of 1949 for wheat, feed grains, upland cotton, extra long staple cotton, rice, honey, and (with respect to clause (iii)(II) of subparagraph (B)) other commodities, when combined with payments for such crop described in paragraph (1), shall not exceed $250,000.

(B) As used in subparagraph (A), the term "payments" means--

(i) any part of any payment that is determined by the Secretary of Agriculture to represent compensation for resource adjustment (excluding land diversion payments) or public access for recreation;

(ii) any disaster payments under one or more of the annual programs for a commodity established under the Agricultural Act of 1949;

(iii)(I) any gain realized by a producer from repaying a loan for a crop of wheat, feed grains, upland cotton, rice, or honey at the rate permitted under section 107D(a)(5), 105C(a)(4), 103A(a)(5), 101A(a)(5), or 201(b)(2), respectively, of the Agricultural Act of 1949, or (II) any gain realized by a producer from repaying a loan for a crop of any other commodity at a lower level than the original loan level established under the Agricultural Act of 1949;

(iv) any deficiency payment received for a crop of wheat or feed grains under section 107D(c)(1) or 105C(c)(1), respectively, or the Agricultural Act of 1949 as the result of a reduction of the loan level for such crop under section 107D(a)(4)or 105C(a)(3) of such Act;

(v) any loan deficiency payment received for a crop of wheat, feed grains, upland cotton, or rice under section 107D(b), 105C(b), 103A(b), or 101A(g), respectively, of the Agricultural Act of 1949; and

(vi) any inventory reduction payment received for a crop of wheat, feed grains, upland cotton, or rice under section 107D(g), 105C(g), 103A(g), or 101A(g), respectively, of the Agricultural Act of 1949.

Such terms shall not include loans or purchases, except as specifically provided for in this paragraph.

(C) The total amount of loans on a crop of honey that a person may have outstanding at any one time under the annual program established for such crop under the Agricultural Act of 1949 may not exceed $250,000 less the amount of payments, as described in paragraph (1) and subparagraphs (A) and (B) of this paragraph, received by such person for the crop year involved.

(3) Notwithstanding the foregoing provisions of this section, if the Secretary of Agriculture determines that any of the limitations provided for in paragraph (2) will result in a substantial increase in the number or dollar amount of loan forfeitures for a crop of a commodity, will substantially reduce the acreage taken out of production under an acreage reduction program for a crop of a commodity, or will cause the market prices for a crop of a commodity to fall substantially below the effective loan rate for the crop, the Secretary shall adjust upward such limitation, under such terms and conditions as the Secretary determines appropriate, as necessary to eliminate such adverse effect on the program involved.

(4) If the Secretary determines that the total amount of payments that will be earned by any person under the program in effect for any crop will be reduced under this section, any acreage requirement established under a set-aside or acreage limitation program for the farm or farms on which such person will be sharing in payments earned under such program shall be adjusted to such extent and in such manner as the Secretary determines will be fair and reasonable in relation to the amount of the payment reduction.

(5)(A) The Secretary shall issue regulations--
(i) defining the term "person"; and
(ii) prescribing such rules as the Secretary determines necessary to assure a fair and reasonable application of the limitation established under this section.
Such regulations shall provide that the term "person" does not include any cooperative association of producers that markets commodities for producers with respect to the commodities so marketed for producers.

(B) The regulations issued by the Secretary on December 18, 1970, under section 101 of the Agricultural Act of 1970 (7 U.S.C. 1307) shall be used to establish the percentage ownership of a corporation by the stockholders of such corporation for the purpose of determining whether such corporation and stockholders are separate persons under this section.

(6) The provisions of this section that limit payments to any person shall not be applicable to lands or animals owned by States, political subdivisions, or agencies thereof, so long as such lands are farmed or animals are husbanded primarily in the direct furtherance of a public function, as determined by the Secretary.

GAO Comments

1. Source: Report to Congress by the Secretary of Agriculture With Respect to the Implementation of the Maximum Payment Limitation, March 10, 1987, Appendix A.

Appendix III

7 CFR 795 - Payment Limitation

Note: GAO comment supplementing those in the report text appear at the end of this appendix.

PART 795—PAYMENT LIMITATION

General

Sec.
795.1 [Reserved]
795.2 Applicability

Definition

795.3 Definition of the term "person"
795.4 Definitions of other terms

Determination Whether Multiple Individuals or Other Entities Constitute One or Separate Persons

795.5 Timing for determining status of persons
795.6 Multiple individuals or other entities
795.7 Entities or joint operations not considered as a person
795.8 Corporations and stockholders
795.9 Estate or trust
795.10 Club, society, fraternal or religious organization
795.11 Husband and wife
795.12 Minor children
795.13 Other cases

Farming Operations

795.14 Changes in farming operations
795.15 Determination whether agreement is a share lease or a cash lease
795.16 Custom farming

Scheme or Device

795.17 Scheme or device

Miscellaneous

795.20 Joint and several liability
795.21 Appeals
795.22 Interpretations
795.23 Paperwork Reduction Act assigned number
795.24 Relief

Authority: Sec. 1001, Pub. L. 99-198, 7 U.S.C. 1308, 99 Stat. 1444.

Source: 43 FR 8784, Mar. 10, 1978, unless otherwise noted.

General

§ 795.1 [Reserved]

§ 795.2 Applicability.

(a) The provisions of this part are applicable to payments when so provided by the individual program regulations under which the payments are made. The amount of the limitation shall be as specified in the individual program regulations.

(b) The limitation shall be applied to the payments for a commodity for a crop year.

(c) The limitation shall not be applicable to payments made to States, political subdivisions, or agencies thereof for participation in the programs on lands owned by such States, political subdivisions, or agencies thereof so long as such lands are farmed primarily in the direct furtherance of a public function. However, the limitation is applicable to persons who rent or lease land owned by States, political subdivisions, or agencies thereof.

(d) The limitation shall not be applicable to payments made to Indian tribal ventures participating in the programs where a responsible official of the Bureau of Indian Affairs or the Indian Tribal Council certifies that no more than the program payment limitation shall accrue directly or indirectly to any individual Indian and the State committee reviews and approves the exemption.

[40 FR 14710, Apr. 13, 1984, as amended at 51 FR 9453, Mar. 11, 1986; 51 FR 36905, Oct. 16, 1986]

Definitions

§ 795.3 Definition of the term "person".

Subject to the provisions of this part, the term "person" shall mean an individual, joint stock company, corporation, association, trust, estate, or other legal entity. In order to be considered a separate person for the purpose of the payment limitation, in addition to the other conditions of this part, the individual or other legal entity must:

(a) Have a separate and distinct interest in the land or the crop involved;

(b) Exercise separate responsibility for such interest; and

(c) Be responsible for the cost of farming related to such interest from a fund or account separate from that of any other individual or entity.

§ 795.4 Definitions of other terms.

In the regulations in this part and in all instructions, forms, and documents in connection therewith, all words and phrases, other than the term "person", shall have the meanings assigned to them in the regulations governing reconstitutions of farms, allotments, and bases, Part 719 of this chapter, as amended.

Determination Whether Multiple Individuals or Other Entities Constitute One or Separate Persons

§ 795.5 Timing for determining status of persons.

Except as otherwise set forth in this part, the status of individuals or entities as of March 1, or such other date as may be determined and announced by the Administrator, shall be the basis on which determinations are made in accordance with this part for the year for which the determination is made.

[51 FR 21630, June 16, 1986; 51 FR 36905, Oct. 16, 1986]

§ 795.6 Multiple individuals or other entities.

The rules in §§ 795.5 through 795.16 shall be used to determine whether certain multiple individuals or legal entities are to be treated as one person or as separate persons for the purpose of applying the limitation. In cases in which more than one rule would appear to be applicable, the rule which is most restrictive on the number of persons shall apply.

§ 795.7 Entities or joint operations not considered as a person.

A partnership, joint venture, tenants in common, or joint tenants shall not be considered as a person but, not

withstanding the provisions of § 795.3, each individual or other legal entity who shares in the proceeds derived from farming by such joint operations shall be considered a separate person, except as otherwise provided in this part, and shall be listed as a producer for payment purposes on program documents. The payment shares listed on the program documents for each individual or other legal entity shall be the same as each individual or other legal entity shares in the proceeds derived from farming by such joint operation. Notwithstanding the foregoing, each individual or other legal entity who shares in the proceeds derived from farming by such joint operation shall not be considered as a separate person unless the individual or other legal entity is actively engaged in the farming operations of the partnership or other joint operation. An individual or other legal entity shall be considered as actively engaged in the farming operation only if its contribution to the joint operation is commensurate with its share in the proceeds derived from farming by such joint operation. Members of the partnership or joint venture must furnish satisfactory evidence that their contributions of land, labor, management, equipment, or capital to the joint operation are commensurate with their claimed shares of the proceeds. A capital contribution may be a direct out-of-pocket input of a specified sum or an amount borrowed by the individual. If the contribution consists substantially of capital, such capital must have been contributed directly to the joint operation by the individual or other legal entity and not acquired as a result of (a) a loan made to the joint operation, (b) a loan which was made to such individual or other legal entity by the joint operation or any of its members or related entities, or (c) a loan made to such individual or other legal entity which was guaranteed by the joint operation or any of its members or related entities.

§ 795.9 Corporations and stockholders.

(a) A corporation (including a limited partnership) shall be considered as one person, and an individual stockholder of the corporation may be considered as a separate person to the extent that such stockholder is engaged in the production of the crop as a separate producer and otherwise meets the requirements of § 795.3 except that a corporation in which more than 50 percent of the stock is owned by an individual (including the stock owned by (1) individual's spouse, minor children, and trusts for the benefit of such minor children) or by a legal entity, shall not be considered as a separate person from such individual or legal entity.

(b) Where the same two or more individuals or other legal entities own more than 50 percent of the stock in each of two or more corporations, all such corporations shall be considered as one person.

(c) The percentage share of the value of the stock owned by an individual or other legal entity shall be determined as of March 1 of the crop year, except that where a stockholder voluntarily acquires stock after March 1 and before the harvest of the crop, the amount of any stock so acquired shall be included in determining the percentage share of the value of the stock owned by the stockholder. Where there is only one class of stock, a stockholder's percentage share of the value of the outstanding stock shall be equal to the percentage of the outstanding stock owned by the stockholder. If the corporation has more than one class of stock the percentage share of the value of the stock owned by a stockholder shall be determined by the Deputy Administrator on the basis of market quotations, and if market quotations are lacking or too scarce to be recognized the percentage share of the value of the stock shall be determined by the Deputy Administrator on the basis of all relevant factors affecting the fair market value, including the rights and privileges of the various stock issues.

(Title I, Agricultural Act of 1970, as amended by the Agriculture and Consumer Protection Act of 1973, Pub. L. 93-86, 87 Stat. 221 (7 U.S.C. 1307) and under Title I, Rice Production Act of 1975, Pub. L. 94-214, 90 Stat. 181 (7 U.S.C. 438k note), and Pub. L. 95-113, 91 Stat. 1266 (7 U.S.C. 1307 note; 7 U.S.C. 1307, 7 U.S.C. 1441))

[42 FR 9784, Mar. 10, 1978, as amended at 45 FR 10311, Feb. 15, 1980; 45 FR 11795, Feb. 22, 1980]

§ 795.9 Estate or trust.

(a) An estate or irrevocable trust shall be considered as one person, except that where two or more estates or irrevocable trusts have common beneficiaries or heirs (including spouses and minor children) with more than a 50-percent interest, all such estates or irrevocable trusts shall be considered as one person.

(b) An individual heir of an estate or beneficiary of a trust may be considered as a separate person to the extent that such heir or beneficiary is engaged in the production of crops as a separate producer and otherwise meets the requirements of § 795.3, except that an estate or irrevocable trust which has a sole heir or beneficiary shall not be considered as a separate person from such heir or beneficiary.

(c) Where an irrevocable trust or an estate is a producer on a farm and one or more of the beneficiaries or heirs of such trust or estate are minor children, the minor children's pro rata share of the program payments to the trust or estate shall be attributed to the parent of the minor children, except as otherwise provided in § 795.12.

(d) A revocable trust shall not be considered as a separate person from the grantor.

§ 795.10 Club, society, fraternal or religious organization.

Each individual club, society, fraternal or religious organization may be considered as a separate person to the extent that each such club, society, fraternal or religious organization is engaged in the production of crops as a separate producer and otherwise meets the requirements of § 795.3.

§ 795.11 Husband and wife.

A husband and wife shall be considered as one person.

§ 795.12 Minor children.

(a) A minor child and his parents or guardian (or other person responsible for him) shall be considered as one person, except that the minor child may be considered as a separate person if such minor child is a producer on a farm in which the parents or guardian or other person responsible for him (including any entity in which the parents or guardian or other person responsible for him has a substantial interest, i.e., more than a 20 percent interest) takes no part in the operation of the farm (including any

activities as a custom farmer) and owns no interest in the farm or allotment or in any portion of the production on the farm, and if such minor child

(1) Is represented by a court-appointed guardian who is required by law to make a separate accounting for the minor and ownership of the farm is vested in the minor, or

(2) Has established and maintains a different household from his parents or guardian and personally carries out the actual farming operations on the farm for which there is a separate accounting, or

(3) Has a farming operation resulting from his being the beneficiary of an irrevocable trust and ownership of the property is vested in the trust or the minor.

(b) A person shall be considered a minor until he reaches 18 years of age. Court proceedings conferring majority on a person under 18 years of age will not change such person's status as a minor for purposes of applying the regulations.

§ 795.13 Other cases.

Where the county committee is unable to determine whether certain individuals or legal entities involved in the production of a commodity are to be treated as one person or separate persons, all the facts regarding the arrangement under which the commodity is produced shall be submitted to the State committee for decision. Where the State committee is unable to determine whether such individuals or legal entities are to be treated as one person or separate persons, all the facts regarding the arrangement under which the farming operation is conducted shall be submitted to the Deputy Administrator for decision.

FARMING OPERATIONS

§ 795.14 Changes in farming operations.

(a) Subject to the provisions of this part, a person may exercise his or her right heretofore existing under law, to divide, sell, transfer, rent, or lease his or her property if such division, sale, transfer, rental arrangement, or lease is legally binding as between the parties thereto. However, any document representing a division, sale, transfer, rental arrangement, or lease which is fictitious or not legally binding as between the parties thereto shall be considered to be for the purpose of evading the payment limitation and shall be disregarded for the purpose of applying the payment limitation. Any change in farming operations that would otherwise serve to increase the number of persons for application of the payment limitation must be bona fide and substantive.

(b) A substantive change includes, for example, a substantial increase or decrease in the size of the farm by purchase, sale, or lease; a substantial increase or decrease in the size of allotment by purchase, sale, or lease; a change from a cash lease to a share lease or vice versa; and dissolution of an entity such as a corporation or partnership.

(c) Examples of the types of changes that would not be considered as substantive are the following:

Example 1. A corporation is owned equally by four shareholders. The corporation owns land, buildings, and equipment and in the prior year carried out substantial farming operations. Three of the shareholders propose forming a partnership which they would own equally. The partnership would cash lease land and equipment from the corporation with the objective of having the three partners considered as separate persons for purposes of applying the payment limitation under the provisions of § 795.7 of the regulations.

The formation of such a partnership and the leasing of land from a corporation in which they hold a major interest would not constitute a substantive and bona fide change in operations. Therefore the corporation and the partners would be limited to a single payment limitation.

Example 2. Three individuals each have individual farming operations which, if continued unchanged, would permit them to have a total of three payment limitations.

The three individuals propose forming a corporation which they would own equally. The corporation would then cash lease a portion of the farmland owned and previously operated by the individuals with the objective of having the corporation considered as a separate person for purposes of applying the payment limitation under the provisions of § 795.8 of the regulations. The formation of such a corporation and the leasing of land from the stockholders would not constitute a substantive and bona fide change in operations. Therefore the corporation and the three individuals would be limited to three payment limitations.

§ 795.15 Determining whether agreement is a share lease or a cash lease.

(a) *Cash lease.* If a rental agreement contains provisions for a guaranteed minimum rental with respect to the amount of rent to be paid to the landlord by a tenant, such agreement shall be considered to be a cash rental agreement. In addition, the rental agreement must be customary and reasonable for the area.

(b) *Share lease.* If a rental agreement contains provisions that require the payment of rent on the basis of the amount of the crop produced or the proceeds derived from the crop, such agreement shall be considered to be a share rental agreement. In addition, the rental agreement must be customary and reasonable for the area.

[51 FR 8434, Mar. 11, 1986 and 51 FR 36905, Oct. 16, 1986]

§ 795.16 Custom farming.

(a) Custom farming is the performance of services on a farm such as land preparation, seeding, cultivating, applying pesticides, and harvesting for hire with remuneration on a unit of work basis, except that, for the purpose of applying the provisions of this section, the harvesting of crops and the application of agricultural chemicals by firms regularly engaged in such businesses shall not be regarded as custom farming. A person performing custom farming shall be considered as being separate from the person for whom the custom farming is performed only if:

(1) The compensation for the custom farming is paid at a unit of work rate customary in the area and is in no way dependent upon the amount of the crop produced, and (2) the person performing the custom farming (and any other entity in which such person has more than a 20-percent interest) has no interest, directly or indirectly, (i) in the crop on the farm by taking any risk in the production of the crop, sharing in the proceeds of the crop, granting or guaranteeing the financing of the crop, (ii) in the allotment on the farm, or (iii) in the farm

as landowner, landlord, mortgage holder, trustee, lienholder, guarantor, agent, manager, tenant, sharecropper, or any other similar capacity.

(b) A person having more than a 20 percent interest in any legal entity performing custom farming shall be considered as being separate from the person for whom the custom farming is performed only if:

(1) The compensation for the custom farming service is paid at a unit of work rate customary in the area and is in no way dependent upon the amount of the crop produced, and (2) the person having such interest in the legal entity performing the custom farming has no interest, directly or indirectly, (i) in the crop on the farm by taking any risk in the production of the crop, sharing in the proceeds of the crop, granting or guaranteeing the financing of the crop, (ii) in the allotment on the farm, or (iii) in the farm as landowner, landlord, mortgage holder, trustee, lienholder, guarantor, agent, manager, tenant, sharecropper, or in any other similar capacity.

SCHEME OR DEVICE

§ 795.17 Scheme or device.

All or any part of the payments otherwise due a person under the upland cotton, wheat, feed grain and rice programs on all farms in which the person has an interest may be withheld or required to be refunded if the person adopts or participates in adopting any scheme or device designed to evade or which has the effect of evading the rules of this part. Such acts shall include, but are not limited to, concealing from the county committee any information having a bearing on the application of the rules of this part or submitting false information to the county committee (for example, a set-aside agreement which is entered into that differs from information furnished to the county committee concerning the manner in which program payments are actually shared; concerning the actual facts of a sale; or concerning the transfer of property; or creating fictitious entities for the purpose of concealing the interest of a person in a farming operation).

MISCELLANEOUS

§ 795.20 Joint and several liability.

Where two or more individuals or legal entities, who are treated as one person hereunder, receive payments which in the aggregate exceed the limitation, such individuals or legal entities shall be liable jointly and severally, for any liability arising therefrom. The provisions of this part requiring the refund of payments shall be applicable in addition to any liability under criminal and civil fraud statutes.

§ 795.21 Appeals.

Any person may obtain reconsideration and review of determinations made under this part in accordance with the appeal regulations, Part 780 of this chapter, as amended.

§ 795.22 Interpretations.

In interpretations previously issued pursuant to the payment limitation regulations and published at 36 FR 16589, 37 FR 3049, 39 FR 15021 and 41 FR 17527 shall be applicable in construing the provisions of this part.

§ 795.23 Paperwork Reduction Act assigned number.

The information collection requirements contained in these regulations (7 CFR Part 795) have been approved by the Office of Management and Budget under the provisions of 44 U.S.C. Chapter 35 and have been assigned OMB control number 0560-0096.

(49 FR 14710, Apr. 13, 1984)

§ 795.24 Relief.

If a producer relied on a county committee and/or State committee "person" determination for a crop year and higher reviewing authority makes a more restrictive determination, the Deputy Administrator may grant relief only for such crop year if the producer was not afforded an opportunity to exercise other alternatives with respect to the producer's farming operation and the program provisions and the county committee has determined that the producers acted in good faith based upon the original "person" determination.

(51 FR 8454, Mar. 11, 1986; 51 FR 36[illegible], Oct. 10, 1986.)

GAO Comment

1. Source: Report to Congress by the Secretary of Agriculture With Respect to the Implementation of the Maximum Payment Limitation, March 10, 1987, Appendix B.

Appendix IV

USDA's Explanation of How the Payment Limitation Is Applied

Note: GAO comment supplementing those in the report text appear at the end of this appendix.

I. DISCUSSION OF CURRENT APPLICATION OF THE PAYMENT LIMITATION

A. MANNER IN WHICH "PERSON" DETERMINATIONS ARE MADE

The Administrator of the Agricultural Stabilization and Conservation Service (ASCS) has been delegated the responsibility of implementing the maximum payment limitation requirement. In order to determine the amount of annual farm program payments a "person" is receiving, ASCS must determine all possible sources through which an individual or entity may be receiving farm program payments. Therefore, producers are required to annually submit information to the local county Agricultural Stabilization and Conservation (ASC) committees detailing all of their interest in farming operations. Forms have been developed for collecting the information needed to make "person" determinations. These forms are as follows:

Number	Title	Appendices
ASCS-561	Farm Operating Plan for Payment Limitation Review (Individual)	C
ASCS-561-A	Farm Operating Plan for Payment Limitation Review for a Limited Partnership, Corporation, Estate or Trust	D
ASCS-561-B	Farm Operating Plan for Payment Limitation Review for Joint Venture or General Partnership	E

Producers must file these forms with the local county ASC committee whenever there is a change in the producer's farming operation from the previous year. If there has been no change, the producer must submit a signed statement to that effect.

Initial "person" determinations are made by the county ASC committee. A producer may appeal a county ASC committee determination to the State ASC committee and ultimately to the Deputy Administrator, State and County Operations, ASCS in accordance with the Administrative Appeal Regulations, 7 CFR Part 780.

B. OVERVIEW OF REGULATIONS GOVERNING THE APPLICATION OF THE PAYMENT LIMITATION.

1. General. The regulations implementing the payment limitation focus primarily on the definition of a "person."

Each producer meeting the definition of a "person" may be eligible to receive the maximum level of annual commodity payments allowed by section 1001 of the Food Security Act of 1985, as amended. The fundamental precept of the regulations is that each producer determined to be a "person" for payment limitation purposes must:

(a) have a separate and distinct interest in the land or the crop involved,

(b) exercise separate responsibility for such interest, and

(c) be responsible for the cost of farming related to such interest from a fund or account separate from that of any other individual or entity.

2. Treatment of Individuals or Entities. In applying the basic concept set forth in item 1 above, the regulations further provide for the treatment of individuals or entities as follows:

(a) Entities or joint operations are not considered to be a "person". Generally, a partnership, joint venture, tenant-in-common, or joint tenant is not considered as a "person" but each individual or other legal entity who shares in the proceeds derived from farming by such joint operations is considered to be a separate person. However, each

individual or other legal entity who shares in the proceeds derived from farming by such joint operation is not considered to be a separate person unless the individual or other legal entity is actively engaged in the farming operations of the partnership or other joint operation.

An individual or other legal entity is to be considered as actively engaged in the farming operation only if its contribution to the joint operation is commensurate with its share in the proceeds derived from farming by such joint operation. Members of the partnership or joint venture must furnish satisfactory evidence that their contributions of land, labor, management, equipment, or capital to the joint operation are commensurate with their claimed shares of the proceeds. A capital contribution may be a direct out-of-pocket input of a specified sum or an amount borrowed by the individual.

If the contribution consists substantially of capital, such capital must have been contributed directly to the joint operation by the individual or other legal entity and not acquired as a result of: (i) a loan made to the joint operation, (ii) a loan which was made to such individual or

other legal entity by the joint operation or any of its members or related entities, or (iii) a loan made to such individual or other legal entity which was guaranteed by the joint operation or any of its members or related entities.

(b) A corporation (including a limited partnership) is considered to be one "person", and an individual stockholder of the corporation may be considered to be a separate "person" to the extent that such stockholder is engaged in the production of the crop as a separate producer and otherwise meets the requirements of the regulations. However an individual stockholder or legal entity that owns more than 50 percent of the stock of a corporation (including the stock owned by the individual's spouse, minor children, and trusts for the benefit of such minor children) shall be combined with the corporation for the purpose of applying the payment limitation.

Where the same two or more individuals or other legal entities own more than 50 percent of the stock in each of two or more corporations, all such corporations are combined for the purpose of applying the payment limitation.

(c) An estate or irrevocable trust is considered to be a "person" except that, where two or more estates or irrevocable trusts have common beneficiaries or heirs (including spouses and minor children) with more than a 50-percent interest, all

such estates or irrevocable trusts are considered to be combined.

An individual heir of an estate or beneficiary of a trust may be considered as a separate "person" apart from the trust or estate to the extent that such heir or beneficiary is engaged in the production of crops as a separate producer and otherwise meets the requirements of the regulations. However, a sole heir or beneficiary of an estate or irrevocable trust shall be combined with the estate or trust.

Where an irrevocable trust or an estate is a producer on a farm and one or more of the beneficiaries or heirs of such trust or estate are minor children, the minor children's pro rata share of the program payments made to the trust or estate is attributed to the parent of the minor children, unless such minor children are determined to be "independent minors." (See subparagraph (f), infra.)

A revocable trust is not considered as a separate "person" from the grantor.

(d) Each individual club, society, fraternal or religious organization is considered to be a separate "person" to the extent that each such club, society, fraternal or religious organization is engaged in the production of crops as a separate producer and otherwise meets the requirements of the regulations.

(e) A husband and wife are considered as one "person."

(f) Minor children and their parents or guardians (or other person responsible for them) are considered to be one "person", except that the minor child may be considered to be a separate "person" if such minor is determined to be "independent." A minor child will be determined to be independent if such minor child is a producer on a farm in which the parents or guardian or other person responsible for the minor child (including any entity in which the parents or guardian or other person responsible for the child has a substantial interest, i.e., more than a 20-percent interest) takes no part in the operation of the farm (including any activities as a custom farmer) and owns no interest in the farm or in any portion of the production on the farm and if such minor child:

(i) Is represented by a court-appointed guardian who is required by law to make a separate accounting for the minor and ownership of the farm is vested in the minor child, or

(ii) Has established and maintains a different household from the minor child's parents or guardian and personally carries out the actual farming operations on the farm for which there is a separate accounting, or

(iii) Has a farming operation as a result of the minor child's being the beneficiary of an irrevocable trust and ownership of the property is vested in the trust or the minor child.

A "person" is considered to be a minor child until attaining 18 years of age. Court proceedings conferring majority on a person under 18 years of age do not change such person's status as a minor for purposes of applying the payment limitation regulations.

3. Substantive Change Rule.

The payment limitation regulations recognize that persons may exercise their right, under law, to divide, sell, transfer, rent, or lease their property. Any change in the farming operations that would otherwise serve to increase the number of persons for application of the payment limitation must be bona fide and substantive.

As examples, a substantive change includes: a substantial increase or decrease in the size of the farm by purchase, sale, or lease; a substantial increase or decrease in the size of allotment by purchase, sale or lease; a change from a cash lease to a share lease or vice versa; and dissolution of an entity such as a corporation or partnership.

Examples of the types of changes that would not be considered as substantive are the following:

Example 1:

A corporation is owned equally by four shareholders. The corporation owns land, buildings, and equipment and in the prior year carried out substantial farming operations. Three of the shareholders propose forming a partnership which they would own equally. The partnership would cash lease land and equipment from the corporation with the objective of having the three partners considered to be separate "persons" for purposes of applying the payment limitation.

The formation of such a partnership and the leasing of land from a corporation in which they hold a major interest would not constitute a substantive and bona fide change in operations. Therefore, the corporation and the partners would be limited to a single payment limitation.

Example 2:

Three individuals each have individual farming operations which, if continued unchanged, would permit them to have a total of three payment limitations. The three individuals propose forming a corporation which they would own equally. The corporation would then cash lease a portion of the

farmland owned and previously operated by the individuals with the objective of having the corporation considered as a separate "person" for purposes of applying the payment limitation. The formation of such a corporation and the leasing of land from the stockholders would not constitute a substantive and bona fide change in operations. Therefore, the corporation and the three individuals would be limited to three payment limitations.

4. Custom Farming. Custom farming is the performance of services on a farm such as land preparation, seeding, cultivating, applying pesticides, and harvesting for hire with remuneration on a unit of work basis, except that, for the purpose of applying the payment limitation, the harvesting of crops and the application of agricultural chemicals by firms regularly engaged in such businesses are not regarded as custom farming.

A person performing custom farming shall be considered to be separate from the person for whom the custom farming is performed only if:

(a) The compensation for the custom farming is paid at a unit of work rate customary in the area and is in no way dependent upon the amount of the crop produced, and

(b) the person performing the custom farming (and any other entity in which such person has more than a 20-percent interest) has no interest, directly or indirectly, (i) in the crop on the farm by taking any risk in the production of the crop, sharing in the proceeds of the crop, granting or guaranteeing the financing of the crop, (ii) in the allotment on the farm, or (iii) in the farm as landowner, landlord, mortgage holder, trustee, lienholder, guarantor, agent, manager, tenant, sharecropper, or any other similar capacity.

A person having more than a 20-percent interest in any legal entity performing custom farming is considered as being separate from the person for whom the custom farming is performed only if:

(a) The compensation for the custom farming service is paid at a unit of work rate customary in the area and is in no way dependent upon the amount of the crop produced, and

(b) the person having such interest in the legal entity performing the custom farming has no interest, directly or indirectly, (i) in the crop on the farm by taking any risk in the production of the crop, sharing

in the proceeds of the crop, granting or guaranteeing the financing of the crop, (ii) in the allotment on the farm, or (iii) in the farm as landowner, landlord, mortgage holder, trustee, lienholder, guarantor, agent, manager, tenant, sharecropper, or in any other similar capacity.

81-879 - 88 - 6

GAO Comment

1. Source: Report to Congress by the Secretary of Agriculture With Respect to the Implementation of the Maximum Payment Limitation, March 10, 1987, pages 1 through 12.

Appendix V

ASCS State and County Offices Included in GAO Review

State	County
California	Butte Kings
Nebraska	Custer Dawson Phelps
Texas	Hockley
Washington	Adams

Appendix VI

USDA's Proposed Amendment to Section 1001 of the Food Security Act of 1985

Note: GAO comment supplementing those in the report text appear at the end of this appendix.

A BILL

To provide for the fair and equitable application of the maximum limitation on farm program payments that may be received by a person.

Be it enacted by the Senate and the House of Representatives in Congress assembled, That section 1001(5) of the Food Security Act of 1985 is amended by striking subparagraph (B) and inserting in lieu thereof the following new subparagraphs (B), (C), and (D):

"(B) In applying the limitation provided for by this section, the Secretary shall—

"(i) provide for similar treatment of all entities;

"(ii) except as provided in clause (iii), determine the amount of payments that may be received by any entity based upon the number of members of the entity who are determined to be actively engaged in farming;

"(iii) consider any entity that is conducting a farming operation independently of all of its members to be a separate person;

"(iv) attribute all payments received by an entity to the members of the entity that have an interest in the entity, such attribution to be based upon the member's interest in the entity; and

"(v) consider an individual or entity to be actively engaged in farming if such individual or entity has made a significant contribution (determined based upon the total value of the farming operation) of (I) land, cash, or equipment, and (II) labor or management to the farming operation.

"(C) For the purpose of this section the term 'entity' means a corporation, trust, estate, limited partnership, general partnership, joint venture, charitable organization and, except as provided in subparagraph (A), any other entity or association.

"(D) The Secretary may determine not to attribute payments to a member of an entity as provided for in subparagraph (B)(iv) if it is determined that—

"(i) such member's interest in the entity is less than 10 percent; and

"(ii) attribution of such payments to such member would have little or no impact on the implementation of the limitation provided for by this section.".

SEC. 2. The amendments provided for by this act shall be effective with respect to the 1988 through 1990 crops of wheat, feed grains, upland cotton, extra long staple cotton, rice, and honey.

GAO Comment

1. Source: Report to Congress by the Secretary of Agriculture With Respect to the Implementation of the Maximum Payment Limitation, March 10, 1987, pages 39 and 40.

Appendix VII

Major Contributors to This Report

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San Francisco Regional Office	Richard Sheldon, Regional Assignment Manager Elizabeth Olivarez, Evaluator Robert Tomcho, Evaluator

Senator HARKIN. Next we will call Milton Hertz, Administrator, ASCS, to talk about the maximum payment limitation provisions.

Mr. Hertz, welcome to the subcommittee, and if you would please introduce your assistants who are with you.

Your prepared statement will be made a part of the record in its entirety, and I would ask you to summarize it, or highlight it, however you would like to proceed.

STATEMENT OF MILTON J. HERTZ, ADMINISTRATOR, AGRICULTURAL STABILIZATION AND CONSERVATION SERVICE, U.S. DEPARTMENT OF AGRICULTURE, WASHINGTON, DC, ACCOMPANIED BY TOM VonGARLEM AND WAYNE MAYFIELD, ASSISTANT DEPUTY ADMINISTRATORS, STATE AND COUNTY OPERATIONS, ASCS

Mr. HERTZ. Thank you, Mr. Chairman.

Mr. Chairman, I have with me Mr. Tom VonGarlem and Mr. Wayne Mayfield, who are the Assistant Deputy Administrators in the administration of the various aspects of the farm bill and are involved with the State and County Operations.

Mr. Chairman and members of the subcommittee, I am pleased to be here today to have this opportunity to discuss with you the maximum payment limitation provisions as well as the specific problem areas that we have encountered with the current applications of the payment limitation rules and some possible alternatives.

We share the concern of many that if we are going to be able to administer this program effectively, we do need a change in legislation; we feel that if legislation can close some of the loopholes that have created some of the monsters that we have looked at earlier, that we can effectively protect the family farms, the legitimate farming operations that everyone seems to have concern for, but feel that as we have made the effort to administratively tighten down, that we have had little success.

We would agree with the GAO and the OIG reports to the extent that we have not done a particularly good job of administering the Payment Limitation Program out in the country. We would agree that we are not consistent, going from one county to the next, going from one State to the next. And I think that, in defense of our county offices, our State offices, when we talk about changing rules, changing applications of "person" determinations, as was suggested in the fall of 1986, I think that this was an outgrowth of those investigations that suggested that we needed to have more training, we needed to have management meetings, we needed to have hands-on, lead some people through to be consistent and apply the rules as they were. And the result of this suggested that we had a substantive change in the regulations in the rules, which is absolutely not true.

I think at this point in time, we found that county offices, State offices, county committeemen, through this training process, were made more aware of some of the responsibilities that they had to look at in making these "person" determinations, and the result of that seemed that we did make some major changes.

As an aside, the result of those supposed major changes had a rather adverse effect, if you will, on the ASCS. The substantive changes as suggested seemed to imply that we were getting tougher, and it was not well-received in the country, it was not well-received in the Congress.

For these reasons, I believe that if we are going to be able to put the teeth into the "person" determinations that we need the legislative change that will give us guidance that so many of the emotional, if you will, determinations are taken out of the actual administration of the program. That is to what we would really look toward.

I believe the legislation that the USDA has proposed, with possibly some fine-tuning—and maybe in some cases it is even overrestrictive—can accomplish these goals.

Mr. Chairman, with that, I would be happy to respond to any questions.

[The prepared statement of Mr. Hertz follows:]

Statement of Milton Hertz
Administrator, Agricultural Stabilization and Conservation Service
U.S. Department of Agriculture
before the
Committee on Agriculture, Nutrition and Forestry
Subcommittee on Nutrition and Investigations
U.S. Senate
July 21, 1987

Mr. Chairman and Members of the Subcommittee, I am pleased to have this opportunity today to discuss with you the maximum payment limitation provisions as well as specific problem areas that we have encountered with the current application of the payment limitation rules and some possible alternatives.

I also wish to take this opportunity to thank the Chairman and the other Members of the Subcommittee for their interest in this most important issue. The earlier report you requested and received from the General Accounting Office and Inspector General tends to support the findings and recommendations of the Secretary of Agriculture in his report to the Congress on this subject.

We share the concern of many that even though new entities are legally being created which have the effect of circumventing the payment limitation, this practice needs to be stopped. Of equal concern is that in our eagerness to curtail the creation of new entities solely for the purpose of avoiding the limitation, we do not want to disrupt legitimate farming operations of long standing, or make it difficult for young people to get into farming.

There must be action on two fronts to combat abuses of the $50,000 payment limitation. First, we need to be more vigilant in administering program rules in response to our own Inspector General's investigation. To assist in this endeavor an Agricultural Stabilization and Conservation Service (ASCS) task force is now working to improve our current procedures.

The second and most important action which is necessary, is closing down loopholes which are used to increase the number of persons for purposes of applying these payment limitation provisions. Some of these loopholes are: (1) the formation of general partnerships and joint ventures which have the effect of creating large numbers of entities that have only small amounts of capital invested; (2) the formation of "paper" corporations; (3) the formation of irrevocable trusts for minor children; and (4) the use of custom farming as a vehicle. Unfortunately, it is not possible to do this purely administratively. The necessary legislative action is already part of the President's farm reform proposals.

As Members of the Subcommittee can appreciate, the creation of new entities and the reorganization of farms can be and is an extremely difficult, complicated, and emotional issue. In fact, thriving concerns have been established solely for the purpose of organizing farming operations in a manner so as to avoid the application of this payment limitation.

Because of this difficulty, ASCS vigorously provided national training for ASCS State and county employees with respect to the application of payment limitation regulations in September and again in December, 1986 and have continued ongoing training. Given the many types of farming we have in this Nation, uniform application of the payment limitation regulations throughout the country is being achieved. However, much progress can be made in this regard. Still, there are persons engaged in very questionable practices aimed at collecting more payments than those to which they are entitled. We need the help of Congress in stopping these abuses.

In all fairness to our State and county ASCS employees and State and county ASC committees, I believe that in total they have done an outstanding job in one of the most difficult and complex areas of program administration.

Mr. Chairman, I could continue to point out the many things ASCS has done to prevent and reduce program abuse; however, I believe our time might be better served by discussing how the Congress and the USDA can work together using additional legislation to develop rules and regulations which will prevent program abuse without preventing the growth and creation of legitimate farming operations for which our programs are intended.

This concludes my statement, Mr. Chairman, and I would be happy to answer any questions.

Senator HARKIN. Thank you very much, Mr. Hertz.

I just have a few questions here for the record. Some of the reforms mentioned in your March 1987 report can be made within the Secretary's existing legislative authority. If payment limit application legislation does not pass in this Congress, can you or do you intend to make revisions within current authority?

I thought I just heard you say that you had some real problems and that you got some resistance.

Mr. HERTZ. Mr. Chairman, our record of making changes in the regulations and in the procedure have been less than successful. And I would go back to the early days of the payment limitation when initially the percentage that a person could own in a corporation was set at 50 percent, and USDA or ASCS administratively at that time recognized that two people could be individuals and the corporation could be an individual. Administratively, that percentage was changed to 20 percent. Very shortly after that, Congress passed a supplemental to the "person" determination that said it had to be at 50 percent.

So, if that is an example, when we suggest that we are going to say let us get tough, we feel that administratively we are not that successful.

Senator HARKIN. So I guess you say legislation is really necessary.

When did ASCS first come to the realization that it had a problem—and please outline the steps you have taken and the efforts you have made to correct that problem administratively. If you cannot answer that all here, if you could just sort of send it to me in writing, I would appreciate it.

Mr. HERTZ. Mr. Chairman, I believe that through our internal control procedures, whenever we find that we have a problem in a given county and a given State, or even through the process of reviewing the number of payment limitations that we do each year, sends up a flag with our own review people, we target particular areas. In fact, I think in most cases of the investigations that OIG has done, they have been at our request. When we find that we have what we would consider a problem area, we seek their help in making an overall audit.

What we have done subsequent to their findings, I think, No. 1 is the training program that we have instituted nationwide.

Senator HARKIN. Was that done just since the March report?

Mr. HERTZ. We started this, yes, about 18 months ago, with the major impact of training.

Senator HARKIN. No. I just wondered what steps you had taken. OIG came out with a report in March of 1987, this March.

Mr. HERTZ. We have gone specifically back into individual counties, looked at the "person" determinations that they questioned——

Senator HARKIN. Oh, so you had some indications prior to that.

Mr. HERTZ. Yes, and subsequent to that, made almost a thorough evaluation. I think one of the States that was involved in the audit, I believe we had 100-some different operations that were looked at where normally we might only look at half a dozen.

Senator HARKIN. Yes, I see.

Have you taken any steps since the March 1987 report, this March 1987 OIG report? Has anything been done since then? Did you come up with the legislation before or after that, this draft legislation?

Mr. HERTZ. I believe the legislation was brought up the 1st of March.

Mr. VONGARLEM. Or within just a few days after the 1st of March.

Senator HARKIN. You had access to this while you were developing the legislation; you knew about this, right?

Mr. HERTZ. Yes.

Senator HARKIN. Again, getting back to the training and such that you were talking about, I want to get a better handle on that.

I heard testimony and comments with respect to lack of training for county office personnel and with respect to unreasonable delays in the appeals process. How many staff persons in Washington have payment limitations as their primary responsibility—I do not know if you know off the top of your head.

Mr. HERTZ. Wayne or Tom?

Mr. VONGARLEM. None.

Senator HARKIN. You have none in Washington who have as their primary responsibility payment limitations?

Mr. VONGARLEM. Right.

Mr. HERTZ. I think what Tom is referring to would be the initial determination of the "person" determination.

Mr. VONGARLEM. Well, I would underline "primary" because there are at least a dozen that work on payment limitations and spend a great deal of their time, but "primary", we have none whose number one job is payment limitations.

Senator HARKIN. But you have about a dozen that look at it as part of other duties?

Mr. VONGARLEM. Yes, sir.

Senator HARKIN. And you do not know what percent of their time or effort is spent on this.

Mr. VONGARLEM. No.

Senator HARKIN. Well, again, I am just wondering couldn't some of the training and delay problems, things like that, some of this administrative work, if we had staff here who looked at that—again, as my staff just informed me, this is a big program, over $8 billion a year—$8 billion a year. And there is no one down there whose primary responsibility is to check into this now, or at least some people who have as their primary responsibility checking into this.

As you know, I chair the Subcommittee on Nutrition and Investigations and I will tell you, let one welfare mother get one extra quart of milk, or one extra juice, or an extra loaf of bread, or a few extra bucks, and I am telling you, the Department is down her throat. And yet here, we have people getting millions of dollars, and as I understand this we have no one in the Department who is looking at this. I just find that a great anomaly.

Mr. HERTZ. Mr. Chairman, I think as Tom VonGarlem is suggesting in the "primary" determination of "persons" that all takes place out at the county level. So our involvement on that is far, far removed. And the involvement that we have here in Washington

through our internal control process, we require a county to send a certain percentage of their "person" determinations to the State office, they in turn send a certain percentage to Washington, and then the people here in Washington, that becomes their primary function in reviewing those, to see if we have consistency between the State and then back again to the county.

If we refer to our appeals staff who get directly involved with many "person" and payment limitation cases, what we have seen happen there with the coming of the 1985 farm bill, there were many, many new provisions of that farm bill that were not a part of the 1981 act—calculations of basis yields, payment limitations, and the overall implementation of it—and a lot of farmers felt they were trapped by that, and we have been absolutely buried with appeals. It is up a couple thousand percent, I would guess, prior to the implementation of this bill. And it is just the transition. We are seeing that tail down now, and I think from the standpoint of our appeals staff, we have almost doubled that in the last year, and to find people that are conversant in or knowledgeable in every aspect of ASCS to be a part of that, it has taken time.

Senator HARKIN. Well, first of all, I do want to compliment you on your frankness and forthrightness when you said this morning that you recognized that they have not been doing too good a job, there have been inconsistencies out there, and that you are addressing those.

I would point out for the record and for those here that you have come forward with recommendations for legislation to correct these things, and I want to compliment you for that. I think that is good.

I just question this idea of a big program and no one really focusing on these payment limits, because it sort of is the mirror image of a Food Stamp Program. You get a couple or three people out there who cheat the Food Stamp Program, people blow this up, and it hurts all the other legitimate people out there who really need it. It is the same way with this program. You get some clowns like the ones we saw on the charts here, doing that, and it makes everybody mad. It makes all the farmers mad, it makes the family farmers mad, and it makes people up here mad. They say, "I thought we had passed the $50,000 payment limitation. Why don't you guys do something about it and take care of it?"

So it really does destroy the program and the intent of the program. As I said in my opening remarks today, the intent of the program is very clear—to target benefits to family-size farmers and to put a limit on it so that these kinds of things will not happen. And I think the legislation that you have proposed will go a long way toward doing that.

Let me ask you this. In GAO's statement that they released today—and I know you have not had a chance to look at it yet—but in my talking with them, they have made a couple of recommendations that they would like to have added to the legislation that you have sent down. Have you had a chance to look at that?

Mr. HERTZ. I have not been able to look at them specifically, but I do not see that they could not be added to the proposed legislation.

Senator HARKIN. Yes. I just want to know what your thoughts are. And again you have not had a chance to examine it—they had

two recommendations for changes that they wanted made—you have not had a chance to examine it?

Mr. HERTZ. No, sir. I believe one of them related to the investor kind of an approach.

Senator HARKIN. Yes, exactly.

What I would like you to do is to take a look at those and provide your thoughts on those two changes so that we will have that as we move this legislation forward and take a look at it.

Mr. HERTZ. We will sure do that.

[The material follows:]

The first proposed GAO amendment would close a loophole that was overlooked by USDA in preparing the March legislative proposal. The amendment provides for combining a producer on rented land with the landowner unless the producer meets specified additional requirements.

The second amendment clarifies a requirement we had believed was included in the USDA proposal. We agree with and support the proposed changes.

Senator HARKIN. You may see some problems in it that we do not see, or something like that. But at least the one that dealt with investors, I can understand that right away. It seems to be pretty good. But at least let us know before we start moving this.

Mr. HERTZ. We certainly will. Mr. Chairman, if I might make one quick comment on how three or four bad apples can create a problem for several others, I believe that in one of the States this year where we thought we had a major bust, we held up millions of dollars worth of payments to the farmers that were involved in multiple "person" determinations and did have legitimate farming programs.

Senator HARKIN. You mean because of this, they were held up.

Mr. HERTZ. Yes, yes, as part of our overall review of that entire package that came out of one of those States, we held up an awful lot of money to some farmers that could have used it and should have had it on time. But there again, they were trapped by——

Senator HARKIN. What State was that? Is that for the record, or——

Mr. HERTZ. It was Arkansas.

Senator HARKIN. Oh, it was Arkansas. I know it is in other States, too, but evidently—there must be a very sharp attorney or somebody down there who is going around the coffee shops and so on and signing people up in this program.

Mr. HERTZ. Well, I would not say I would specifically point the finger at Arkansas; however, that is one of the States that the audit was performed in and say we only found 2 percent of them that audit felt was in bad shape; why, it tended to put the entire focus on all the farmers of that State, and that is guilty by association, and they do no worse or no better than anybody else down there.

Senator HARKIN. Of course, they had an impetus to do this in those States, because of the marketing loan for rice; is that not true?

Mr. HERTZ. Yes—well, not necessarily the marketing loan; more the deficiency payment.

Senator HARKIN. Well, now, let's see. The Findlay portion of that is not subject, right?

Mr. HERTZ. The Findlay portion would be subject to the $200,000.

Senator HARKIN. I guess, then, it is just because of this huge increase in the deficiency payment, where it went from $3.90 to $4.82 in 2 years.

Mr. HERTZ. Yes. I believe with an average yield per farm of a little over 200 acres, a rice farm will hit the $50,000 payment limit from deficiency payments.

Senator HARKIN. Well, we are anxious to start working on this legislation. It is something that we have to do and we have to do right away. I am hopeful that we will have the support in the committee to move it expeditiously. I know the chairman himself is interested in this, and I can tell you there is a lot of interest from my colleagues in the Senate in doing something about this.

Again, I would like to ask you to look at the recommendation made by GAO to see if you see any problems with it and what you might recommend.

Do you have an internal audit group in ASCS, or do you rely on OIG?

Mr. HERTZ. We have an internal—we do not call it an audit group, but an internal review group. We have individuals in each State that are not assigned to any particular county office, but go from one county office to the next, reviewing the application of the various ASCS procedures.

Senator HARKIN. What did your internal review group come up with in this thing?

Mr. HERTZ. They found inconsistencies in many cases in interpretation of the procedure.

Senator HARKIN. From State to State?

Mr. HERTZ. From State to State, yes; and even from county to county, in some cases.

Senator HARKIN. I guess, then, what you are saying is that you need the legislation, but then you are going to do a better job of training and directing and guiding those people so that we do not have these kinds of problems.

Mr. HERTZ. Yes. And I would hope that the legislation would have a clarity in it that would relieve the county committees of some of the judgment decisions that they have to make. I think in many cases, with the county elected committeemen making a judgment on their neighbor, whether he is one person or two or multiple, the emotions, the neighbor aspect enters in, and it is tough for them. And sometimes, I think we have found that those folks have maybe taken the easy way out, not wanting to be adverse on their fellow farmers in that given community.

And I believe with maybe some more specific language within the legislation that would give less guidance, if you will, less options, in making the "person" determinations, we could run the program a whole lot cleaner.

Senator HARKIN. Do you have any kind of centralized authority or control over the local activities? What kind of centralized authority or control over local activities do you have?

Mr. HERTZ. We have the organizational structure that starts in each State with a State executive director, and serving for him are State specialists and district directors. These district directors are, you might say, the oversight management of a number of counties, 6, 7, 8, maybe 10 counties, and they will be a roving individual

going from one county to the next, doing internal control work and also acting as a resource for those people if they are having problems with the procedure. And then within the State offices, we have the specialists in the individual areas of each program that the county offices can use for review.

I think one of the things that is going to greatly enhance our overall management is that we are in the process of automating all of our county offices, and once we have the entire automation package in place, that computer is only going to perform a function one way and one way all over the country. And we feel that from an internal control, from a management standpoint, that is going to enhance our thoroughness, if you will, but I do not know what kind of percent. It is going to be of a very, very high percentage that we are going to cut back on errors.

Senator HARKIN. If you had one farmer that got two $50,000 payments from different States, would you have some way of catching that?

Mr. HERTZ. Yes.

Senator HARKIN. You do?

Mr. HERTZ. Yes.

Senator HARKIN. Well, we look forward to working with you, and again I want to thank you for your frankness and your forthrightness, for coming up with this legislation, working with OIG and GAO in covering this and getting it out. I am hopeful that we can work with you on this legislation and get it through.

Mr. HERTZ. Thank you, Mr. Chairman. I would just commit to you that we would be available to you to do whatever task you would ask of us in helping put together legislation, discussions of different aspects of "person" determination or any part of it, we would commit to see that happen—because we are going to be the ultimate ones that are going to benefit from it.

Senator HARKIN. I appreciate it. I agree with Senator Pryor when he said—did he say this was "outrageous" or "scandalous"—I do not know. Whatever he did not say, I will say. It really is outrageous that we allow this to happen, and we have got to tighten down on it if we want to save any farm programs at all.

So again, thank you very much, and you will let me know about those GAO recommendations as soon as possible.

Mr. HERTZ. Yes, sir.

Senator HARKIN. Thank you very much.

Mr. HERTZ. Thank you.

Senator HARKIN. The subcommittee will stand adjourned subject to the call of the Chair.

[Whereupon, at 12:22 p.m., the subcommittee was adjourned subject to the call of the Chair.]

[Material submitted for inclusion in the record follows:]

Questions for USDA

1. Some of the reforms mentioned in your March 1987 report can be made within the Secretary's existing legislative authority. If payment limit application legislation does not pass in this Congress, do you intend to make revisions within current authority?

2. In your opinion, is legislation necessary to accomplish the goal of applying the payment limit in a fair and equitable manner to all producers?

3. Have you performed any analyses of payment records or other data that would indicate which types of farm business organizations would be (a) most affected and, alternatively, (b) least affected, by the proposed revisions? If so, would you describe them.

4. What portion of "persons," as they are currently defined, receiving payments for 1987 crops would be affected by the proposed revisions?

5. What actions has the Department taken in response to the Inspector General's March 1987 report that found widespread errors in the administration of the payment limit?

6. How often has the Department used the "scheme or device" section of the payment limit rules to deny "person" status? What are the considerations in applying this section?

7. When a limit on direct payments was first established in 1970, the dollar limit was higher for cotton and rice than for wheat and feed grains. It has been suggested that the payments for these crops should be higher to reflect their higher production expenses. Do you have any views on:

   (a) whether the limit for cotton, rice, or any other crop should be higher, and if so,

   (b) what the limit should be?

8. What procedures are routinely employed to prevent circumvention of the payment limitation from one CO to another? Bow effective are these procedures?

9. Please provide, for the record, your views on the attached amendments, proposed by GAO, to the legislation proposed by USDA to close loopholes in the $50,000 payment limitation.

USDA'S PROPOSED AMENDMENT TO SECTION 1001(5) OF THE FOOD AND SECURITY ACTO OF 1985, AS AMENDED, WITH NECESSARY REVISIONS TO CLOSE LOOPHOLES IDENTIFIED BY GAO

(Necessary revisions are in **bold type**)

A BILL

To provide for the fair and equitable application of the maximum limitation on farm program payments that may be received by a person.

Be it enacted by the Senate and the House of Representatives in Congress assembled, That section 1001(5) of the Food Security Act of 1985 is amended **by inserting at the end of subparagraph (A) the following new sentence: "Such regulations shall provide that a producer who rents or leases land from an individual or entity must be combined as one person for payment limitation purposes with the individual or entity from whom the land is rented or leased unless the producer makes a substantial contribution of owned land or owned equipment and personal labor or active personal management to the farming operation that includes the rented or leased land."** and by striking subparagraph (B) and inserting in lieu thereof the following new subparagraphs (B), (C), and (D):

"(B) In applying the limitation provided for by this section, the Secretary shall-

"(i) provide for similar treatment of all entities;

"(ii) except as provided in clause (iii), determine the amount of payments that may be received by any entity

based upon the number of members of the entity who are determined to be actively engaged in farming;

"(iii) consider any entity that is conducting a farming operation independently of all its members to be a separate person and combine as one separate person all entities that are owned or controlled by the same one or more individual(s);

"(iv) attribute all payments received by an entity to the members of the entity that have an interest in the entity, such attribution to be based upon the member's interest in the entity, except that total payments attributed to a member of an entity may not exceed the payment limits provided for by this section when added to payments received by that member as a separate person or to payments attributed to that member from another entity or other entities in which that member has an interest; and

"(v) consider an individual or entity to be actively engaged in farming if such individual or entity has made a significant contribution (determined based upon the total value of the farming operation) of (I) land, cash or equipment, and (II) labor or management to the farming operation.

"(C) For the purpose of this section the term 'entity' means a corporation, trust, estate, limited partnership, general partnership, joint venture, charitable organization and,

except as provided in subparagraph (A), any other entity or association.

"(D) The Secretary may determine not to attribute payments to a member of an entity as provided for in subparagraph (B)(iv) if it is determined that--

"(i) such member's interest in the entity is less than 10 percent; and

"(ii) attribution of such payments to such member would have little or no impact on the implementation of the limitation provided for by this section.".

SEC. 2. The amendments provided for by this act shall be effective with respect to the 1988 through 1990 crops of wheat, feed grains, upland cotton, extra long staple cotton, rice, and honey.

QUESTIONS FOR USDA AND SUPPLIED ANSWERS

Question 1. Some of the reforms mentioned in your March 1987 report can be made within the Secretary's existing legislative authority. If payment limit application legislation does not pass in this Congress, do you intend to make revisions within current authority?

Answer: It has not yet been conclusively determined.

Questions 2. In your opinion, is legislation necessary to accomplish the goal of applying the payment limit in a fair and equitable manner to all producers?

Answer: Yes. We believe that with the exception of the items commented on in question number 9, that the proposed legislation is necessary to provide for the fair and equitable implementation of the payment limitation.

Questions 3. Have you performed any analyses of payment records or other data that would indicate which types of farm business organizations would be (a) most affected and, alternatively, (b) least affected, by the proposed revisions? If so, would you describe them.

Answer: No, such analyses have not been performed.

Question 4. What portion of "persons", as they are currently defined, receiving payments for the 1987 crops would be affected by the proposed revisions?

Answer: Unknown. The General Accounting Office (GAO) has made two studies addressing this question that would more properly provide a response.

Question 5: What actions have the Department taken in response to the Inspector General's March 1987 report that found widespread errors in the administration of the payment limit?

Answer: We are currently looking into the feasibility of developing an "expert" software system which would assist us in providing uniform application of person determinations.

Question 6: How often has the Department used the "scheme or device" section of the payment limit rules to deny "person" status? What are the considerations in applying this section?

Answer: The Department has used the "scheme or device" section of the payment limitation rules to deny "person" status in 12 cases. These cases involve situations where either the farming plan approved by the County Agricultural Stabilization and Conservation committee was knowingly and willfully circumvented or where all entities involved in a case cooperated to create additional "persons" for the expressed intent of evading the payment limitation provisions.

Question 7: When a limit on direct payments was first established in 1970, the dollar limit was higher for cotton and rice than for wheat and feed grains. It has been suggested that the payments for these crops should be higher to reflect their higher production expenses. Do you have any views on:

(a) whether the limit for cotton, rice, or any other crop should be higher, and if so,

(b) what the limit should be?

Answer: (a) No; (b) not applicable.

Question 8: What procedures are routinely employed to prevent circumvention of the payment limitation from one county office to another? How effective are these procedures?

Answer: Combined entity and multiply-county producer files are maintained for each county office at the Kansas City Management Office (KCMO) to track payments made to entities operating in more than one county. Reports are generated to each county office showing the producers combined with other entities and showing producers operating in more than one county. One county office is designated as a "control county" to coordinate payments among all counties where a producer is farming and to ensure the payment limitation is not exceeded. KCMO generates after-the-fact payment limitation reports to assure that the payment limitation was not exceeded.

Question 9: Please provide, for the record, your views on the attached amendments, proposed by GAO, to the legislation proposed by USDA to close loopholes in the $50,000 payment limitation.

Answer: Section 1001 (4) - We do not believe producers, except in cases of a scheme or device, should be required to make any refunds if such producer operated in reliance upon a "person" determination made by an authorized representative of the Secretary.

Section 1001 (5) - We believe that husbands and wives should be considered one "person" for payment limitation purposes as the conceptual approach governing payment limitation is to limit the payment that may be received by a single economic unit to a legislated amount.

WRITTEN STATEMENT OF THE NATIONAL GRANGE
SUBMITTED TO THE
SUBCOMMITTEE ON NUTRITION AND INVESTIGATION
OF THE
SENATE AGRICULTURE, NUTRITION, AND FORESTRY COMMITTEE
UNITED STATES SENATE
JULY 21, 1987

RE: LIMITATION ON DIRECT PRICE-SUPPORT PAYMENTS MADE ANNUALLY TO ONE PERSON

Mr. Chairman, members of the Subcommittee, the National Grange appreciates the opportunity to present its views on the enforcement of the current agricultural program payment limitations. The National Grange is a general farm organization, representing over 365,000 members in 42 states.

The Grange has testified before the Senate Agriculture Committee on numerous occasions in strong support of commodity programs that explicitly target benefits to moderate-size commercial farms. In this regard, we have suggested strict enforcement of the $50,000 payment limitation on program benefits. Today, we will concentrate our remarks on the fraud and abuse that has taken place in efforts to avert the current payment limitations.

First of all, Mr. Chairman, the National Grange believes that the Department of Agriculture is partially at fault in some cases where "bogus" reconstitutions have occurred. Local County Committees and County ASCS (Agriculture Stabilization and Conservation Service) offices and officials have not properly applied payment limitation rules and regulations and in many cases, they have not required producers to provide accurate and complete information to facilitate correct "person" determinations. As a result, we have seen an inconsistent application of the regulations regarding the organization of farms. The General Accounting Office (GAO) has identified a number of areas where the USDA could act to correct these problems. The Grange hopes that the Department and Congress will heed these recommendations in an effort to correct the existing problem of fraud and abuse.

While the National Grange strongly supports efforts aimed at eliminating program fraud and abuse, we do not believe that the rules and regulations of the payment limitation should be designed to interfere with traditional family-oriented operations and agreements. For this reason, we support the concept passed in section 636 of the Agriculture, Rural Development and Related Agencies Appropriation Act of 1987. The legislation said, "Effective for each of the 1987 through 1990 crops, the Secretary may not deny a person's status as a separate person solely on the ground that a family member cosigns for, or makes a loan to, such person and leases, loans, or gives such person equipment, land or labor, if such family members were organized as separate units prior to December 31, 1985." This language was included in Public Law 99-500 and Public Law 99-591.

As mentioned above, the Grange supports the intent of section 636 but believes the language needs to be modified to better protect family agreement and to guard against fraud and abuse. We suggest the following to replace section 636 of the Agriculture, Rural Development and Related Agencies Appropriations Act of 1987: "Effective for each of the 1987 through 1990 crops, the Secretary may not deny an individual status as a separate person

solely on the ground that a family member co-signs for, or makes a loan to, such individual and/or leases, loans or gives such individual equipment or labor and/or leases such individual land."

Four changes are made from section 636 to the National Grange's suggested language. First, the word "person" is changed to "individual" in three places. The Department has apparently interpreted the word "person" in those three cases to mean a person in the form of an individual and not in the form of a joint stock company, corporation, association, trust or similar legal entity (summary section of proposed rule for 7 CFR Part 795 - Payment Limitation, Page 9302 of the Federal Register, Volume 52, Number 56, Tuesday, March 24, 1987). We believe this to be a correct interpretation, but also feel that changing the word "person" to "individual" would take away any doubt.

Second, the Grange suggests replacing the "and" between the phrase on loans and the phrase on equipment, land or labor with "and/or". The law as written suggests that both co-signing or making a loan and leasing, loaning or giving equipment, land or labor must occur. We are confident that this was not the intent of lawmakers and changing "and" to "and/or" will clarify that one or the other or both are not grounds for the denial of separate person status.

The third recommended change removes the word "land" and adds after "labor", "and/or leases land". As it is currently written, the law allows a family member to lease, loan or give the person equipment, land or labor. This wording would allow a father and son to produce on the same farm but qualify for two payment limitations. By eliminating the ability to loan or give land to a family member, the law would force a separate farm to be established to qualify for a separate payment limitation (all other conditions must be met as well).

And fourth, we would recommend the deletion of "if such family members were organized as separate units prior to December 31, 1985". The word "organized" is currently creating problems in administering this language. For example, a father and son in Oklahoma have been determined to not qualify because they were organized as one unit prior to December 31, 1985; however, they were treated as two persons prior to section 636 with regard to the payment limitation. Senator Don Nickles has introduced a piece of legislation which changes "organized" to "treated". This is the least that should be done. However, the National Grange questions the need for the historic perspective at all. If a family operation is organized or treated as a separate unit at any time, assuming all other qualifications are met, then status prior to December 31, 1985 should not be grounds for the denial of separate person status.

The National Grange recommended to the Department that the definition of a "family member" should include lineal ancestors and descendants of an individual and the brother and sister of an individual. This includes as a "family member" the individual and the great grandparent, grandparent, parent, child, grandchild, brother and sister of such individual and the spouses of all such individuals. This definition of "family member" is narrower than the definition of "family member" in 2032A of the Tax Code but is broader than that proposed on Page 9303 of the March 24th Federal Register due to the inclusion of brother and sister. The final rule published on July 14th did not include this recommended change.

The remainder of our testimony will deal with particular ideas aimed at reducing fraud and abuse of the current law and suggestions that will give ASCS offices a clearer directive on what is and what is not an acceptable reorganization. In some cases, we will give particular recommendations while in other cases, we will highlight what we feel to be a problem. In both cases, we look forward to working with you, Mr. Chairman, and any member of this Subcommittee to develop legislation which will implement solutions to this growing problem.

Passive investors in agriculture have caused many of the overproduction and surplus problems encountered in agriculture today. During the debate and consideration of the Tax Reform Act of 1986, almost all agricultural and commodity organizations agreed that the passive investor should not enjoy the same tax breaks which true agricultural producers enjoy. Farm policy should follow that same path. Passive investors should not qualify as a separate person for the purpose of payment limits. The National Grange believes that for an individual to qualify as a separate person, they should be forced to make a significant contribution to the farming operation. The Grange recommends that a person must be an "active participant" to qualify. We further suggest that "active participation" be defined consistent with the definition in the Tax Code which requires the individual to participate in making the management decisions or arranging for others to provide services in a significant and bona fide sense and to own no less than 10 percent (by value) of the operation. This change will discourage the addition of an individual to an operation solely for the purpose of increasing the number of payment limitations.

If an operation undergoes a substantive change, there may be grounds for the addition of additional "persons". However, we must be certain that rather than a fictitious agreement based on evading the payment limitation, that a bona fide change has occurred. The National Grange supports and recommends the Department's three part proposal to accomplish this goal: 1) a decrease in the size of a farming operation does not qualify as a substantial change for the purpose of increasing the number of persons on the farm; 2) if the "substantial change" in the operation is an increase in the size of the operation, such size increase must bear a reasonable relationship to the number of persons being added to the operation; 3) a change from cash to share rent would only serve as justification for the owner of the land to be added as another person in the farming operation.

Examples have been brought forth where a few individuals have dramatically increased their payment limitations by forming a number of corporations or similar legal entities. These situations have not only included passive investors but also family members trying to avert the payment limit (one father, four sons and one daughter became eligible for 21 payment limitations by forming corporations consisting of two individuals per entity). The current attribution regulations are inconsistent, unfairly penalizing some while others effectively avoid the payment limitation. A number of concepts may be applicable to solving the attribution problem. They range from one payment limitation per social security number to attribution of payments received based upon the individual's interest in the entity, to total no more than the payment limit ($50,000) per individual.

The Department has recommended that where the same two or more persons have 50 percent or more interest in each of two or more entities, all such entities should be considered to be one "person" for payment limitation purposes. One or some combination of these ideas may become necessary to stop the "bogus" corporation formation, especially if brothers and sisters are added to the definition of a "family member".

Other areas where regulations may need to be tightened and where the Department of Agriculture, and in some cases, the General Accounting Office have made recommendations include the person status of a minor and wife, estates, irrevokable trusts, the similar treatment of entities, the person status of foreign investors, and the person status of a custom farming operation. These situations and others need attention and the National Grange would be happy to work with this Subcommittee in developing solutions for these concerns.

The last area which the Grange will address in this testimony is the definition of a "person". As finalized in the July 14th Federal Register on Page 26295, the term "person" shall mean an individual, joint stock company, corporation, association, trust, estate, or other legal entity. To be a "separate person", such person must a) have a separate and distinct interest in the crop or the land on which the crop is produced; b) exercise separate responsibility for such interest; c) be responsible to pay the cost of farming related to such interest from a fund or account separate from that of any other individual or entity.

While in the past the National Grange has approved of the above definition, maybe we all need to take a second look. Possibly, a more narrowly defined "person" and "separate person" would eliminate some fraud and abuse. One idea that has been suggested is to define a "person" as a social security number and a "separate person" as a social security number that meets a, b and c above as well as other qualifications in the law. The definition could include a "person" as an individual producer only, stipulating that interests in other legal entities are not "separate persons", or modify current rules so that these legal entities could only be "separate persons" if the stockholders of the entity each own less than a 50 percent interest. Even the current definition could be modified to state that general partnerships and joint ventures could only be one "person" and that corporation and all individual stockholders could only be considered one "person". These are thoughts we must all strongly consider.

Stopping program fraud and abuse has a number of benefits. They include public perception, efficient allocation of taxpayers' money (subsidizing the small- and medium-size commercial family farmer), and budgetary savings (the GAO estimates that a continuation of the current trend could cost $2.3 billion over the 6-year period from 1984 to 1989) to name a few. This is an issue which we in the agricultural industry must address and correct. We at the National Grange look forward to helping lawmakers stop agricultural program fraud and abuse.

81-879 (176)